PUBLIC ACCOUNTING and AUDITING

HENRY R. HATFIELD
2695 LE CONTE AVENUE
BERKELEY CALIFORNIA

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Volume II

By

J. F. SHERWOOD

Certified Public Accountant and Auditor

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PREFACE

This is the second volume of a two-volume series. A knowledge of the subject-matter discussed in Volume One is necessary in order to comprehend the discussion in Volume Two.

This volume relates to various phases of accountancy dealing principally with problems encountered by the practicing public accountant and auditor. As each topic is taken up, it is discussed as to accounting principles and practice.

Chapters One to Three relate to partnership accounting problems, the discussion covering transactions incident to organization, operation and dissolution.

Chapters Four to Seven relate to corporation accounting problems, the discussion covering transactions incident to organization; transactions incident to the handling of various classes of capital stock; transactions relating to dividends, and the accounting for mergers and consolidations.

Chapters Eight to Eleven relate to systematization in which appear a discussion of Mercantile Accounting, Departmentalization, Flour Mill Accounting and Cost Accounting. This discussion is, of necessity, of an elementary nature. No attempt has been made to exhaust the subject. It is felt that it is better to discuss the fundamental principles incident to systematization and apply them to a few particular concerns, thereby creating an interest on the part of the student to continue the study of this important phase of accounting by further investigation and research work.

Chapters Twelve to Fifteen relate to the Federal Income and Surtaxes on Individuals and to the Federal Income and Excess Profits Taxes on Corporations. Two chapters are devoted to individuals and two to corporations.

The questions for class discussion and the problems for practice work are selected from the C. P. A. and Institute examinations. The author has attempted to select and grade the problems so that they apply to the topics under discussion in each chapter and that the student may be led from the known to the unknown. In other words, it is believed that the student with the proper preliminary training, who has mastered the principles of accounting and auditing as presented in Volume One, should be able to take up Volume Two and complete the work without difficulty, provided he masters the additional principles and phases of accounting as they are developed in the discussion.

In conclusion, the author desires to thank those teachers and practicing accountants who have offered many helpful suggestions in connection with the preparation of the manuscript. He is especially indebted to E. R. Thoma, Instructor of Accounting, University of Washington; W. O. Winkler, C. P. A., Dean, School of Commerce, Valparaiso University, and George E. Bennett, C. P. A., Professor of Accounting, Syracuse University, for the material assistance rendered in the preparation of the manuscript for this volume. He also feels indebted to Paul F. Fusselman, attorney at law, income tax inspector, U. S. Treasury Department, for the assistance rendered in connection with the preparation of the manuscript relating to the Federal Income and Excess Profits Taxes.

The author realizes that there may be many imperfections in the present volume, and he shall gratefully receive any constructive criticisms and suggestions with which he may be favored by those teachers who, because of their experience in presenting the subject to students, are in a position to make such suggestions as may be worthy of consideration and which it may be found advisable to incorporate in another edition of this volume which it is hoped will appear in the course of time.

J. F. SHERWOOD, C. P. A.

Cincinnati, Ohio.
July 1, 1921.

CONTENTS

Chapter One

PARTNERSHIP ACCOUNTING

1. ACCOUNTING THEORY

In most particulars there is no essential difference between the records and accounts of a partnership and those of a sole proprietorship or a corporation. With the exception of the proprietorship accounts, no new or different accounts are necessary and no new principles are introduced. Certain problems may arise, however, in the conduct of a partnership which do not arise in the conduct of a sole proprietorship or a corporation.

The essential problems of partnership accounting are those which bear upon the character of the partnership relation and refer to the proper division to be made of profits and losses, and of the assets and liabilities at time of dissolution of the partnership. If it is clearly understood in each case just what contract has been made there is ordinarily little difficulty in formulating the accounts. But, unfortunately, the terms of partnership agreements are at times vague, and even the courts have not always agreed on their interpretation. Some of the cases in which difficulties arise are, therefore, of importance to the accountant even though there may be no really vital accounting principles involved.

The principal difficulties in partnership accounting arise in connection with:

1. Partnership organization.
2. Distribution of profits and losses.
3. Partnership dissolution.

Partnership Organization. With reference to the questions arising in connection with the organization of partnerships, only a few can be mentioned here:

Equal Investments. If A. M. Reichard and J. E. Nobis agree to form a partnership, the former investing $25,000.00 in cash and the latter $25,000.00 in merchandise, their financial condition may be expressed as follows:

Balance Sheet

Assets		Liabilities	
Cash	$25,000.00	Net Worth:	
Merchandise	25,000.00	A. M. Reichard, Capital	$25,000.00
		J. E. Nobis, Capital	25,000.00
	$50,000.00		$50,000.00

Overvaluation of Inventories. In this case the only question involved is the value of the merchandise. If it is correctly valued there is no difficulty. It is important that its value be correct for if it later develops that it was overvalued and worth only $20,000.00, the $5,000.00 loss will not fall entirely on Nobis, but must be equally shared by Reichard.

Capital Proportional to Investments. If Nobis invests $30,000.00 of merchandise instead of $25,000.00, with the understanding that his interest in the firm is to be proportional to his investment, no difficulty arises, as his Capital account will be increased to $30,000.00 and Reichard's will remain as before.

Investing Good Will. If, however, Reichard is already engaged in business with an investment of $25,000.00 in miscellaneous assets and Nobis agrees to invest $30,000.00 in cash in order to be admitted as owner of a half interest in the new firm, a new element enters. Since Nobis is willing to invest $30,000.00 in order to be an equal partner with Reichard who is investing only $25,000.00 in tangible assets, he must believe that the good will of Reichard's business is worth $5,000.00. Upon this basis the condition of the new firm may be expressed as follows:

Balance Sheet

Assets		Liabilities	
Misc. Assets	$25,000.00	Net Worth:	
Cash	30,000.00	A. M. Reichard, Capital	$30,000.00
Good Will	5,000.00	J. E. Nobis, Capital	30,000.00
	$60,000.00		$60,000.00

It will be seen from the above illustration that the value of the good will has been credited to Reichard's account since he is the one who has contributed the good will.

If one firm purchases the business of another for a price greater than the net tangible assets of the former, the difference between the purchase price and the net assets must be debited to Good Will.

Reserve for Depreciation of Assets Invested. If, on the other hand, the business is purchased for less than the book value of the net assets, the question arises as to how the difference is to be shown. Some argue that each asset should be scaled down proportionately so that the book value of the net assets will be equal to the purchase price. This would seem to lead to unsatisfactory results, since all of the assets are probably not equally overstated. Some may be worth their book value while others may be entirely worthless. It would seem better to credit the difference between the two amounts to a reserve account and to charge to this account any assets regarded as worthless or any losses arising from their liquidation.

If, when all the assets purchased from the old firm have been liquidated or the value of those still on hand has been accurately verified by means of an appraisal, the reserve account shows a credit balance, this amount may be shared equally by the partners and should be credited to their capital accounts. It should not be treated as a profit arising from the purchase of the business because a profit is realized only through a sale and not through a purchase. It simply represents an adjustment of the partners' capital accounts. If, on the other hand, the account shows a debit balance, this should also be shared equally and charged to the partners' capital accounts. Some accountants might charge this to Good Will, but the policy would certainly be a poor one. It is undoubtedly better practice to make the adjustment through the partners' capital accounts.

To illustrate the above points, we may assume that Reichard and Nobis purchase the business of John Brown, whose financial condition is shown by the following:

Balance Sheet

Assets		Liabilities	
Cash	$ 4,000.00	Accounts Payable	$ 3,000.00
Accounts Rec.	6,000.00	Notes Payable	1,950.00
Merchandise	5,000.00	Accrued Wages	750.00
Notes Receivable	1,000.00	Accrued Taxes	250.00
Furniture and Fix.	500.00	Accrued Interest	50.00
Mach. and Tools	1,500.00		
Land	1,000.00	Net Worth:	
Buildings	2,000.00	John Brown,	
		Capital	15,000.00
	$21,000.00		$21,000.00

If Reichard and Nobis agree to assume Brown's liabilities and to pay him $9,000.00 for his assets exclusive of cash and to invest $1,000.00 each in cash, their financial condition may be represented by the following:

Balance Sheet

Assets		Liabilities	
Cash	$ 2,000.00	Accounts Payable	$ 3,000.00
Accounts Rec.	6,000.00	Notes Payable	1,950.00
Merchandise	5,000.00	Accrued Wages	750.00
Notes Receivable	1,000.00	Accrued Taxes	250.00
Furniture and Fix.	500.00	Accrued Interest	50.00
Mach. and Tools	1,500.00	Res. for Depr. of Assets	2,000.00
Land	1,000.00		
Buildings	2,000.00	Net Worth:	
		A. M. Reichard, Capital	5,500.00
		J. E. Nobis, Capital	5,500.00
	$19,000.00		$19,000.00

If an appraisal of the land places its value at $800.00, the following adjustment would be made:

Res. for Depr. of Assets..........$200.00
  Land........................ $200.00

If $600.00 due from customers finally proves uncollectible, there would be another adjustment:

Res. for Depr. of Assets..........$600.00
  Due from Customers........... $600.00

If the merchandise is liquidated without loss, the reserve for depreciation of assets would show a credit balance of $1,200.00 which would be divided equally between Reichard and Nobis and credited to their capital accounts.

If, on the other hand, the merchandise should prove to be grossly overstated, entailing a loss of $1,600.00 in liquidation, thereby causing an additional debit of this amount to the reserve for depreciation of assets, this account will show a debit balance of $400.00. Since this results in a loss greater than was provided for by a reserve, the excess ($400.00) must be shared equally by the partners. Some might charge this to good will but this would be a questionable policy. There is simply an extraordinary loss and it is better practice to adjust the partners' capital accounts.

Distribution of Profits and Losses. The second class of difficulties involved in partnership accounting as mentioned above are those which arise in connection with the distribution of profits and losses. Legally, in the absence of an agreement to the contrary, profits and losses are divided equally among the partners regardless of the amount of their investments In case of unequal investments, therefore, it is customary for the partners to stipulate in the partnership agreement that profits and losses are to be divided in proportion to the capital invested or on some other basis.

Interest on Capital. In some cases, it is desired to make the division of profits correspond to the ability and influence of the different members or to the amount of time which they devote in the conduct of the business rather than to the capital invested. In such cases, interest at an agreed rate is allowed on the capital invested or sometimes only on the amount invested above a certain sum in order to compensate the members in proportion to the amount invested. Sometimes, in stating how this interest shall be treated on the records, grievous accounting errors are made. For instance, it is sometimes stipulated in the case of two partners that interest shall be figured on the excess investment of the larger investor and credited to his account and debited to the account of the smaller investor.

If Reichard and Nobis are partners, with an investment of $10,000.00 and $5,000.00 respectively, and it is agreed that Reichard is to receive credit at 6% for his excess investment, according to this plan Nobis will be charged $300.00 for the use of the $5,000.00 which is used in the conduct of the joint business of which Reichard will receive the benefit the same as Nobis if profits are shared equally. It is only necessary to assume that Davies, an outsider, instead of Reichard, loaned the money to the firm to see the correct procedure. In that case, the amount of the interest paid Davies would be charged to the Interest account, and be treated as a charge against profits of the firm, and the same procedure should be followed in case the $5,000.00 is contributed by Reichard, as an additional investment. If all of the partners are credited with interest on their investments, it should be considered as a distribution of profits and should be charged to Profit and Loss instead of Interest. Interest credited to a partner on his excess investment is in the nature of interest on borrowed capital and is a proper charge to the Interest account. In case the profit-sharing ratio is proportional to the capital investment, it is useless to provide for the allowance of interest on capital, as it would not affect the results in any way.

Distribution of Profits as Salary. Sometimes the partnership agreement provides for the payment of a certain per cent. of the net profits to one of the partners as a salary for his services. In this case, it is important to know whether by "net profits" is meant the profits after the salary is deducted or before it is deducted; that is, whether the salary is to be regarded as an expense of the business or a division of the profits. It makes considerable difference in the final results as to which interpretation is accepted. To illustrate: If Reichard and Nobis are engaged in a partnership business managed by Reichard with the agreement that Reichard is to receive 25% of the net profits as a salary, the remainder to be divided equally among the two partners and the profits before deducting Reichard's salary are $30,000.00, the following solutions would illustrate the results under the different interpretations.

If the 25% allowance for salary is regarded as a distribution of the profits, the result would be as follows:

A. M. Reichard, for salary, 25%....	$ 7,500.00	
50% of $22,500.00...............	11,250.00	$18,750.00
J. E. Nobis, 50% of $22,500.00.....		11,250.00
		$30,000.00

If, on the other hand, Reichard's salary is to be regarded as an operating expense, the $30,000.00 profits are not net but include his salary in addition to net profits. Since his salary is 25% of net profits, the $30,000.00 must be 125% of net profits and the latter would equal to $24,000.00. The division would now be:

A. M. Reichard, for salary.........	$ 6,000.00	
50% of $24,000.00..............	12,000.00	$18,000.00
J. E. Nobis, 50% of $24,000.00.....		12,000.00
		$30,000.00

It will be seen, therefore, that it is important that the agreement should specify clearly which method is to be followed.

Distribution of Profits in Proportion to Investments. If the partnership agreement states that profits are to be divided in proportion to the investment and the investment does not remain the same throughout the year, the question may arise as to whether in the figuring of profits the basis used should be:

1. The capital at the beginning of the period.
2. The capital at the end of the period.
3. The average capital during the period.

The last would seem to be the most equitable. It is found by multiplying the capital invested by each partner by the number of days it remains unchanged, adding the totals which will be equal to his total investment for one day. When all are reduced to this basis, the profits can be distributed on the basis of the proportion of the different totals.

Interest on Investment a Fixed Charge. In case the partnership agreement provides for the payment of interest on the investments of the partners, this interest should be recorded regardless of whether profits are made. This is treated as a fixed charge and must be debited to the Profit and Loss account.

The Profit and Loss account is usually closed into the partners' accounts at the end of the fiscal period. If there is a net gain, the amount is credited to the partners, and if there is a net loss the amount is charged to the partners. The gain or loss may be recorded in the partners' capital or drawing accounts. Since it is supposed that drawings have been made against anticipated profits, the latter method is often employed. In either case, the balance of the drawing account is usually transferred to the capital accounts at the close of the fiscal period.

2. AUDITING THEORY

Partnership Agreements. A partnership agreement in writing corresponds to the minute book of a corporation. As a corporation is bound by its by-laws, so are partners bound by their partnership agreement.

The auditor should insist upon the partnership agreement being produced. It should be carefully read and notes taken with regard to any important matters relating to the finances, accounts, rights and liabilities of the individual partners.

In the event there is no partnership agreement in writing or the agreement is lacking in matters of importance, the following general information should be secured if possible.

1. The nature and scope of the business.

2. The amount of the original capital.

3. The agreement as to contribution of original capital.

4. Are partners permitted to make withdrawals from their investment? If so, to what extent?

5. Upon what basis are profits to be distributed or losses shared?

6. Are partners allowed a specified salary? If so, is such salary to be charged to expense before or after determining the profit or loss for the period?

7. Are partners entitled to interest on the capital invested? If so, at what rate and on what basis is it to be calculated?

8. In case of dissolution, how are profits or losses incident to realization and liquidation of assets and liabilities to be distributed?

9. Is there an agreement that a scientific system of accounts should be kept, and is it provided that the accounts should be audited periodically by a professional accountant?

10. Are there any special agreements with regard to any matters of importance not outlined above?

After ascertaining all the important phases of the partnership agreement, the auditor should be able to detect any violation of the agreement, and should call each partner's attention to the matter at once. Even though the auditor is employed by one of the partners, he must remain unbiased and neutral. Otherwise, in case of litigation, or in a suit for an accounting, the auditor may find himself in an embarrassing position.

3. PARTNERSHIP LAW

Dr. Jackson, of England, in a paper read some years ago before the Chartered Accountants Students' Societies of Kingston-upon-Hull, England, said:

"Next to the contract of marriage, the contract of partnership is perhaps the most far-reaching legal contract; it requires the utmost good faith between the parties. It deals not only with the status of the firm created by the partnership agreement; it treats not only of the relationship of the parties among themselves and with the firm, but it introduces the various combinations of rights and obligations which may arise between the firm or its respective partners and the world at large."

Partnership is the relation between two or more persons in which they have united their capital, labor, skill, or experience in the prosecution of a business, as principals, for their mutual benefit.

A partnership may be formed by any of three methods:

(a) Oral contract.

(b) Written contract.

(c) Implication, or implied contract.

A partnership which is to be terminated within a year may be formed by an oral contract, but if it is to run longer than a year, the Statute of Frauds requires that the contract be in writing or that there be written evidence of a contract. Undoubtedly, there should be a written contract in all cases of partnership agreement. It will avoid possible misunderstanding and will enable the partners to know at any time just what their rights are as against each other. In case of death of one of the partners, there can be no doubt as to the understanding between partners.

Articles of Copartnership. Written agreements that form a partnership are known as Articles of Copartnership and should include among other things the following:

(a) Name of the firm.
(b) Nature of the business.
(c) Location of the business.
(d) Names of the partners.
(e) Investment of each partner.
(f) Duties of the partners.
(g) Division of profits and losses.
(h) Division of assets in dissolution.

Essential Elements. From the preceding definition, we may deduce certain essential elements of every partnership agreement.

(a) There must be an evident intent to enter into a partnership agreement. This may be manifested by a contract or agreement, either expressed or implied, written or oral, which establishes a legal relationship between partners.

(b) Only persons competent to contract may enter into a partnership agreement.

(c) The partners must agree to contribute a common fund, property, skill, or services for a business to be owned in common.

(d) There must be a community of control in which each partner is authorized to act for the other or others.

(e) The business for which the partnership is organized must be a lawful enterprise, otherwise the agreement would be unenforceable.

(f) The partners must agree to divide the profits and share the losses. This is sometimes implied. In the absence of an agreement, it is understood that the profits and losses are to be divided equally.

Classes of Partnerships. Partnership organizations may be classified as general, implied, or limited.

Implied Partnership. When the acts and language of two or more parties establish the presumption of a partnership regardless of the relations between the parties, they are liable to third parties as partners.

Limited Partnership. While the law regulating limited partnership varies in the different states, the following are the principal features:

(a) One or more of the partners are known as special partners. These special partners contribute to the capital, but are not liable for debts of the firm beyond the amount contributed.

(b) Limited partnerships are required to publish the names of all partners, length and nature of the partnership, and the amount invested by both general and special partners.

(c) Special partners have no voice in the conduct of the business. They may examine the condition of the business from time to time, but if they interfere in the management or enter into firm transactions, they become liable as general partners.

(d) Special partners are prohibited from withdrawing their capital in the form of dividends, profits, loans, or salaries, but they may assign their interest without the consent of the general partners.

General Partnership. In a general partnership, the members associate together in conducting the business. They are liable in common for firm debts. General partners can not assign their interests without the consent of the other members. Every partner is an agent of the partnership in carrying on the ordinary affairs of the business.

Secret Partner. A secret partner (sometimes called a dormant or sleeping partner) is one who contributes in the general management and shares in the profits. He is liable equally with the other partners, but as he is not known to the public he often escapes liability.

Silent Partner. A silent partner takes no active part in the business and he usually does not announce his connection with the firm. He may share in the profits and is liable for the firm debts just as are the general partners.

Nominal Partner. A nominal partner is one who allows his name to be used or to appear as that of a partner. He has no share in the profits, but is liable with the other partners for firm debts.

Ostensible Partner. An ostensible partner is one who appears to the public, or is held forth as a partner, though, in reality he has not contributed to the capital nor does not share in the profits. He may be held liable for firm debts.

4. AUDITING PRACTICE

J. M. Patterson and J. L. Terbush, Certified Public Accountants, are engaged to make an audit of the accounts of the firm of McMahan, Olds & Company for the fiscal period ending June 30, 1920, and are to make a report showing the results of the year's operation, including the proper adjustment of the accounts at the time of the partnership organization, and a Balance Sheet after final adjustments are made.

Preliminary information shows that McMahan, Olds & Company is a partnership organized one year previous, on July 1, 1919. At that time the partnership, which had been conducted by R. G. McMahan and L. B. Olds, decided to admit M. S. Cole as a partner. The partnership agreement showed the following facts:

Cole was to contribute $30,000.00 and was to be entitled to one-third of the profits for one year.

Before making the contribution, the following changes were to be made on the books of McMahan and Olds:

(a) Book value of the store to be written down 5%.

(b) Allowance for doubtful accounts to be set up, amounting to 2%.

(c) Merchandise to be revalued at $35,000.00.

(d) Furniture and Fixtures to be revalued at $2,500.00.

At the end of the year, the amount of good will is to be fixed at three times the net profits in excess of $20,000.00, this good will to be set up on the books, the corresponding credit being to McMahan and Olds equally.

After the good will is determined at the end of the year, Cole was to contribute enough cash so that his capital account would equal just one-third of the total capital.

McMahan, Olds and Cole are each entitled to draw $3,000.00 in cash, the remaining profits to be carried to their capital accounts.

On June 30, 1919, the Balance Sheet* of McMahan and Olds exhibited the following financial condition:

McMAHAN & OLDS

Balance Sheet, June 30, 1919

Assets		Liabilities	
Store	$15,000.00	Accounts Payable	$10,000.00
Accts. Receivable	12,000.00	Bills Payable	5,000.00
Cash	9,000.00	Net Worth:	
Fur. and Fix.	2,800.00	R. G. McMahan, Capital	30,000.00
Merchandise	37,000.00	L. B. Olds, Capital	35,000.00
Misc. Equipment	4,200.00		
	$80,000.00		$80,000.00

The audit showed that the following transactions were consummated during the course of the year:

Merchandise bought on credit	$240,000.00
Cash purchases	25,000.00
Cash sales	125,000.00
Credit sales	175,000.00
Accounts payable paid (face $245,000.00, discount 2 per cent.)	240,100.00
Accounts receivable collected (face $170,000.00, all net except $50,000.00 on which 2 per cent. discount was allowed)	169,000.00
Buying expenses, paid cash	1,500.00
Selling expenses, paid cash	21,000.00
Delivery expenses, paid cash	9,000.00
Management expenses, paid cash	4,500.00
Miscellaneous expense, paid cash	3,000.00
Interest on notes payable, paid cash	250.00
Partners each withdrew cash per agreement	3,000.00

*This engagement does not comprehend an audit of the Balance Sheet of McMahan and Olds as of June 30, 1919. It covers the period beginning July 1, 1919, and ending June 30, 1920. Therefore, the accounts as shown are as submitted by the clients.

The following additional information was secured and agreed upon:

Inventory of merchandise, June 30, 1920...	$60,000.00
Depreciation on store....................	285.00
Allowance for doubtful accounts..........	165.00
Furniture and fixtures to be written down....	200.00

You may assume that you are employed by Patterson and Terbush, Certified Public Accountants. The preceding information is taken from the working papers prepared by the accountants at the office of the client. You are instructed to prepare a report from the information given, your report to consist of the following:

(1) Correcting entries necessary to correctly state the accounts at the beginning of the period, July 1, 1919.

(2) Adjusting entries incident to the preparation of a financial statement, at June 30, 1920.

(3) A Statement of Profit and Loss as at June 30, 1920.

(4) A Balance Sheet as at June 30, 1920.

(5) Closing journal entries.

(6) An auditor's certificate to be qualified on account of the fact that the inventory was not taken under your supervision but stating that you tested it and found it to be correct as tested.

(7) Comments, with suggestions as to improving the system of accounts in use. You may assume that the books of account are poorly planned and improperly kept. A satisfactory internal check is not maintained.

A. THEORY QUESTIONS

1. Wherein do the books of a copartnership differ from those of a corporation in the same line of business?
C. P. A. Ex.

2. What distinction, if any, would you make as to salaries and drawings of the partners in a partnership concern, as affecting profit and loss? C. P. A. Ex.

3. In case you were consulted by prospective partners regarding the terms of a partnership agreement, what points would you recommend for incorporating in such agreement?
C. P. A. Ex.

4. In an equal partnership with three partners, one was unable to meet his share of the investment with cash and gave his note drawing interest for part. When he paid the interest, the bookkeeper credited each of the other partners for one-half of the same. He objected and the matter is referred to you at

the time of the audit. He claims it should have been credited to Interest account and thus have been divided between all three. Write your decision and reasons therefor.

C. P. A. Ex.

5. A and B are in partnership, A receiving two-thirds and B one-third of the profits. On November 30, 1919, the Profit and Loss account (after charging interest on net capital as of end of fiscal period at 5 per cent.) showed a profit of $6,000.00. On the first of December, 1918, the start of the year under audit, A had a capital of $10,000.00 in his business and during the year drew out $4,500.00. B on the same date had a capital of $8,000.00 and during the year drew out $1,000.00.

Make up the two capital accounts as they should appear on November 30, 1919. C. P. A. Ex.

B. LEGAL QUESTIONS

1. Define partnership. State five essential elements of partnership. C. P. A. Ex.

2. What is the difference between an ordinary partnership and a limited partnership? C. P. A. Ex.

3. Who is a nominal, a secret, a dormant, or an ostensible partner? C. P. A. Ex.

4. To what extent may the acts of one partner bind the other partner? C. P. A. Ex.

5. Is the individual property of a copartner liable for a copartner's debts? C. P. A. Ex.

6. Is contribution to the capital of a business necessary to constitute one a partner in same? Explain. C. P. A. Ex.

7. A, who is engaged in carrying on a mercantile business, borrows money of B and promises the latter a compensation for its use equal to 10% of the enterprise. Is B liable as A's partner for the debts of the business? C. P. A. Ex.

8. A, B and C respectively contribute ten, eight and six thousand dollars to the capital of a partnership. How should the resulting losses and gains be distributed in the absence of any agreement as to their distribution?

Inst. Ex.

C. ACCOUNTING PROBLEMS

1. Smith, Hill and Davis form a partnership under an agreement that Smith is to have a salary of $200.00, Hill $150.00, and Davis $100.00 a month respectively. The profits are to be divided in proportion to the amount of business secured by each partner. The partners are to be individually responsible for any direct losses arising from their own business.

They are in business nine months, at the end of which their books show the following:

Smith's sales	$5,310.00
Hill's sales	3,100.00
Davis' sales	3,200.00
Net profits	2,468.50

They then decide to rescind the salary agreement, treating any salary drawn as an advance, but otherwise to divide the profits according to the original arrangement.

You find errors during the nine months' period, namely:

Office furniture, charged to operation	$ 65.00
Fund lent by Davis, credited to his salary account	400.00

and open items not entered on the books as follows:

Smith's salary (ninth month)	$200.00
Hill's salary (ninth month)	150.00
Advertising	27.50
Clerk hire	130.00
Telephone	6.00
Rent	50.00
Stationery	15.00
Accounts Receivable, Smith's business, uncollectible	210.00

and that the sales represent a gross profit of 100% over cost of merchandise.

Set up the journal entries necessary to readjust the accounts. Prepare a correct Profit and Loss statement and a statement showing the distribution of the profits. Inst. Ex.

(Note. The salaries paid to partners should have been charged, according to the original agreement, to Profit and Loss. It is evident, however, from the information given, that the salaries have not been charged to Profit and Loss. The net profits of $2,468.50 must have resulted from the following:

Gross Profit on Sales		$5,805.00
Deduct:		
Expenses of Operation	$3,271.50	
Furniture charged to Operation	65.00	3,336.50
Net Profits		$2,468.50

Since the salary agreement has been rescinded, and all salaries drawn are to be considered advances, it is not necessary to make an adjusting entry. The fact that Davis' salary for the ninth month has been set up while the others partners' salaries have not been set up, indicates that the entries were made when the salaries were drawn; hence the salary accounts can be considered as drawing accounts. Since Smith and Hill have made no drawings during the ninth month no entry is necessary.)

2. A and B, each carrying on a similar business, agree to form a partnership, the new firm to take over the assets and assume the liabilities of each. The following Trial Balances representing the book accounts were presented:

A

Capital		$40,000.00
Machinery and Fixtures	$30,000.00	
Cash	2,000.00	
Bills Receivable	5,000.00	
Accounts Receivable	30,000.00	
Inventory Merchandise	25,000.00	
Wages	7,000.00	
Wages Due		250.00
Expense	10,000.00	
Bills Payable		10,000.00
Merchandise Account		40,000.00
Accounts Payable		20,000.00
Repairs	1,250.00	
	$110,250.00	$110,250.00

B

Capital		$50,000.00
Machinery and Fixtures	$30,000.00	
Cash	4,000.00	
Bills Receivable	8,000.00	
Accounts Receivable	40,000.00	
Wages	9,000.00	
Wages Due		500.00
General Expense	15,000.00	
Bills Payable		15,000.00
Merchandise Account		50,000.00
Inventory	32,000.00	
Repair Account	2,500.00	
Accounts Payable		25,000.00
	$140,500.00	$140,500.00

Formulate opening entry for the new firm. Each partner is to draw half the profits. A profit of $30,000.00 is made during the first year. Set up journal entry to divide the profit between the partners. C. P. A. Ex.

3. A. Wells, a manufacturer of novelties, is joined by I. M. Anxious in partnership upon the following terms:

A. Wells is to receive a monthly salary of $100.00 for the first year, which shall be a first charge upon the profit after providing for the usual business expenses and before reckoning 3% upon the partner's capital. In the event of such profit during the first year, or any subsequent year, not exceeding 6% of the total capital (after payment of the salary), this salary shall be reduced to $75.00 per month the following year, and remain so until the yearly profit advances to more than 6%, when such salary shall return to $100.00, commencing the year succeeding the one showing the required increase of profit.

Should the profit in any one year amount to more than 10% upon capital, A. Wells shall be entitled (in addition to the salary he has received for that year) to a bonus of 33⅓% upon any sum in excess up to $1,500.00 and 25% upon any further excess, and this bonus shall be a charge against profit, before allotting the interest at 3% upon capital. Any profit then remaining shall be divided equally. From the following particulars, construct separate capital accounts for partners for five years, starting capital:

A. Wells, $6,000.00, I. M. Anxious, $5,000.00.

Profit before deducting salary, interest or bonus:

1st year	$1,750.00
2d year	1,800.00
3d year	4,250.00
4th year	5,000.00
5th year	5,500.00

No drawing on account. Distribution of profits when ascertained. C. P. A. Ex.

(Note. To solve this problem, use a sheet of ledger paper. Open accounts allowing a full page for each partner. Close the accounts at the end of each year and bring down the partners' present capital. The problem states that the salary is paid monthly. At the end of the year, under the conditions stated, the partners may also receive a bonus. You may assume that both the salary and bonus were paid in cash. The interest on the investment and the net profits should be credited to the partners' capital accounts.)

4. In making an audit of the books of the partnership of A and B, you find that the agreed division of profits was to be on the basis of the capitals and of the time they were left in the business.

The books show as follows: A's account, paid in January 1, $6,000.00; March 1, $2,000.00; June 1, $4,000.00; November 1, $1,000.00; withdrew, April 1, $3,000.00; October 1, $2,000.00.

B's account, paid in January 1, $4,000.00; February 1, $1,000.00; August 1, $3,000.00; withdrew, May 1, $2,000.00; December 1, $1,000.00.

Prepare statements showing method of arriving at correct profit distribution. C. P. A. Ex.

Chapter Two

PARTNERSHIP ACCOUNTING

1. ACCOUNTING THEORY

Partnership Dissolution. As was shown in the preceding discussion of partnership accounting, the principal work of the public accountant is in connection with the organization, the distribution of the profits and losses, and the dissolution of the partnership.

At the time of dissolution, profits and losses must be properly divided between partners. The remaining assets, after all outstanding obligations or liabilities have been liquidated, must also be properly divided between the partners.

Distribution of Profits and Losses. The profits and losses may be of two classes—those resulting from operations and those resulting from dissolution. However, there is no difference in the basis of the distribution. All profits and losses are to be shared in accordance with the partnership agreement. In the absence of any agreement, either oral or written, they must be shared equally.

Distribution of Assets. After the operating profits or losses have been properly distributed, the usual procedure is to convert the assets into cash (this is known as realization of assets) and to pay all obligations to outside creditors. (This is known as liquidating liabilities.) After liabilities to outside creditors have been liquidated, any liabilities to individual partners should be liquidated. For instance, if a partner has loaned a sum of money to the firm and accepted the firm's note, he is entitled to a settlement after outside creditors are satisfied and before distribution of the remaining assets to partners.

The net assets, usually in the form of cash, must be distributed to partners on the basis of their net investments at time of distribution. In other words, the partners are entitled to withdraw the net capital as shown by their respective capital accounts after all adjustments have been made provided there are sufficient assets. Of course, if an agreement exists as to the distribution of profits, the distribution must be made in accordance with the agreement.

Liquidating Dividends. Usually the process of realization of assets and liquidation of dividends extends over a long period of time, and it is not infrequent that the partners may desire to make a partial distribution of assets before all have been realized upon. Such a partial distribution is known as a liquidating dividend.

The difficulty in distributing a part of the assets before realization of assets and liquidation of liabilities have been entirely completed, lies in the danger of overpaying certain partners. If the one in charge of the liquidation should overpay a partner, and the overpayment cannot be recovered, he may be held liable to the other partners for the amount of the loss incurred. Such an overpayment may easily occur when the profit and loss sharing ratio is different from the capital sharing ratio and large and unexpected losses occur in the process of realization and liquidation.

To illustrate: Assume that the following represents the Balance Sheet of the A, B, C Company, which is being liquidated by H:

Balance Sheet

Assets		Liabilities	
Cash	$1,000.00	Creditors	$20,000.00
Accounts Rec.	15,000.00		
Merchandise	29,000.00	Net Worth:	
		A Capital	5,000.00
		B Capital	10,000.00
		C Capital	10,000.00
	$45,000.00		$45,000.00

A has been in active charge of the business and, as a consequence, the partnership agreement provides that profits and losses are to be shared equally. H receives $34,000.00 from the sale of merchandise and collects $5,000.00 of the accounts receivable. It will be seen that he realized a profit of $5,000.00 on the sale of merchandise. The cash balance is increased to $40,000.00. The profit is distributed equally among the partners and the liabilities are liquidated. The remainder, $15,000.00, is distributed to the partners on the ratio of their investment. (This is known as a liquidating dividend.) The condition of the firm would then be as follows:

Balance Sheet

Assets		Liabilities	
Accounts Rec.	$10,000.00	Net Worth:	
		A Capital	$ 2,000.00
		B Capital	4,000.00
		C Capital	4,000.00
	$10,000.00		$10,000.00

If it should now be determined that $9,000.00 of the accounts receivable amounting to $10,000.00 are uncollectible and worthless, the loss must be shared equally in accordance with the agreement, therefore, ⅓ or $3,000.00 of this loss would be chargeable to A. His account would then show a debit of $1,000.00. H must collect this sum from A before he can return

the investment of B and C. If this amount is later found to be uncollectible, H would be liable to B and C for the loss sustained.

In order to avoid such a result as the above, Hatfield and Walton suggest that the first liquidating dividends be paid not on the basis of the investment of the different partners, but so as to reduce their investment accounts to the same ratio as their profit or loss sharing ratio. After this equilibrium is once attained, future losses and liquidating dividends will be shared on the same basis, therefore, there would be no danger of an overpayment. As to whether the court would uphold such a plan if any of the partners objected to it is very doubtful.

If objection to this method of distribution is made, the liquidator could either refuse to make any partial payments at all until all assets have been converted into cash and all liabilities liquidated, when a final settlement could be made and each partner could then be permitted to withdraw his net capital, provided there were sufficient assets. The liquidator, in some instances, can make a partial dividend of the cash on hand on the basis of the proportionate capital provided he reserves enough cash to secure himself from any contingency arising from an unexpected loss in the realization of remaining assets.

2. PARTNERSHIP LAW

- Partnership Dissolution
  - 1. By Acts of Partners
    - Contractual Agreement
    - Mutual Agreement
    - Withdrawal
    - Sale or Assignment
  - 2. By Operation of Law
    - Death
    - Bankruptcy
      - of firm
      - of a partner
    - War
  - 3. By Decree of Court
    - Misconduct
    - Fraud
    - Breach of Contract
    - Insanity
    - Imprisonment

Dissolution. A partnership is formed by contract. It may be terminated in a similar manner. If in the original, or in a subsequent agreement, it was agreed that the partnership be dissolved at a certain time, the dissolution is said to be "by agreement," or "by acts of the partners." There is nothing to prevent a dissolution of a partnership at any time previous to time of agreed dissolution. One cannot be compelled to remain a partner against his wishes. A court may decree dissolution of a partnership. Misconduct, fraud, bad faith, breach of partnership contract, incapacity of a partner due to insanity, imprisonment, etc., are all common causes for dissolution "by decree of court."

Liability of Withdrawing Partner. If a partner withdraws before termination of the partnership in accordance with the agreement and without the mutual consent of all the partners, he may be held liable to them for any losses they may sustain due to his withdrawal. If the partnership was not formed for a specific length of time, or was not limited to the accomplishment of a certain purpose for which it was formed, the withdrawing partner cannot be held liable for damages sustained by other partners on account of his withdrawal.

Liability to Creditors. Notice of withdrawal or retirement should be given to all persons who have had dealings with the firm, and to the public at large, by the partner who is withdrawing. This will enable him to avoid liability to creditors who may extend credit to the partnership thinking he is still a partner. He cannot escape liability for obligations contracted while he was a partner, but by properly announcing his withdrawal, he may escape liability for the future obligations of the firm.

In case creditors secure a judgment against the firm, executions may be levied either on the firm property or on the separate property of any one of the partners. In other words, the creditors may take judgment against any or all the partners and may collect claims out of the firm's assets or from the property owned by any one or more of the partners. The partners will have to adjust the matter between themselves afterward as best they can. This indicates the importance of the use of proper care in associating one's self in a partnership with others. A partner's personal estate though not invested in the partnership is subject to assessment in case the firm assets are not sufficient to pay the obligation. A partner is also liable for any damages that may result from fraud, torts, or other acts of his partners. However, a partner usually will not be held criminally liable for the acts of his partners.

Division of Profits and Losses. Profits and losses from operations previous to dissolution are shared in accordance with the partnership agreement. In the absence of an agreement, they are shared equally. Profits and losses incident to dissolution are shared on the same basis, unless otherwise specified.

Division of Assets. In the absence of any agreement, the amount of each partner's investment is returned to him in full upon dissolution of the partnership, provided there are sufficient assets. If there are not sufficient assets to return the investments of the partners, there is said to be a capital loss.

In the event there is no agreement to the contrary, profits and losses are shared equally, while the proceeds of the liquidation are distributed on the basis of the investment.

Loan of Partner. If a partner has made a loan to the firm, it is important that this be shown so that it can be easily

proven in case of liquidation. According to law, the outside creditors are first paid from the proceeds of the liquidation, then the loans to partners, and finally the remainder is distributed among the partners. It will be seen, therefore, that in case of a loan, the partner will be recompensed before the other partners receive any of their investment. It may make considerable difference, therefore, as to whether additional money put into the business is to be an investment or a loan.

3. ACCOUNTING PRACTICE

The problems appearing in the various state C. P. A. examinations and in the examinations held by the American Institute of Accountants are a fair indication of the kind of problems encountered by an accountant in public practice. Many of these problems relate to partnership dissolution.

Proposition A.

The following problem taken from a recent C. P. A. examination is an example of one of the most common classes of problems relating to partnership dissolution.

"The following Trial Balance is taken from the books of a partnership in which profits and losses are shared equally:

Building and Equipment	$10,000.00	
Merchandise Inventory	8,000.00	
Accounts Receivable	5,000.00	
Profit and Loss	7,700.00	
A Drawing	3,000.00	
B Drawing	1,500.00	
C Drawing	2,800.00	
A Capital		$15,000.00
B Capital		10,000.00
C Capital		6,000.00
Accounts Payable		7,000.00
	$38,000.00	$38,000.00

The firm decided to sell the business and dissolve the partnership, and procured a purchaser who offered the sum of $12,000.00 for the business, including the good will. The offer was ultimately accepted on the understanding that the purchaser would assume all existing liabilities, which he agreed to do, and the sale was forthwith consummated.

Draft journal entries incident to the sale of the business and dissolution of the partnership and construct ledger accounts showing the settlement of the partnership."

Solution

It will be noted that the partnership agreement provides for equal distribution of profits and losses. Nothing is said about distribution of the cash received from the sale of the entire business, hence, this must be distributed on the basis of the partners' investments.

The transaction incident to the sale of the business may be set up in journal form, it simply being necessary to debit the proper accounts for the liabilities assumed by the purchaser, the cash received, the loss sustained, and to credit the proper accounts for the assets parted with.

Accounts Payable............	$ 7,000.00	
Cash........................	12,000.00	
Profit and Loss...............	4,000.00	
Buildings and Equipment,		$10,000.00
Merchandise Inventory....		8,000.00
Accounts Receivable......		5,000.00

Sold the entire business, including good will. It is agreed that the purchaser will assume all existing liabilities.

Analysis of the Profit and Loss account now shows an operating loss of $7,700.00 and a liquidating loss of $4,000.00. Operating losses are to be shared equally, but nothing is said about liquidating losses, hence they must be shared on the same basis as operating losses.

A Drawing..................	$ 3,900.00	
B Drawing..................	3,900.00	
C Drawing..................	3,900.00	
Profit and Loss...........		$11,700.00

To charge the net loss into the partners' drawing accounts, each partner sharing the profits or losses equally, as per partnership agreement.

It is now necessary to close each partner's drawing account into his capital account.

A Capital....................	$ 6,900.00	
B Capital....................	5,400.00	
C Capital....................	6,700.00	
A Drawing.............		$6,900.00
B Drawing.............		5,400.00
C Drawing.............		6,700.00

To close partners' drawing accounts into their respective capital accounts.

After posting the above entries, the capital accounts of the partners will appear as follows:

A Capital		B Capital		C Capital	
$6,900.00	$15,000.00	$5,400.00	$10,000.00	$6,700.00	$6,000.00

Analysis of the partners' capital accounts now reveals that C's withdrawals plus his share of the losses amount to more than his investment, consequently he is indebted to A and B for the excess amounting to $700.00. If C is solvent, he must pay back this sum in cash.

Cash..........................	$700.00	
C Capital.................		$700.00
In dissolving the partnership it was found that C had overdrawn his account, and it was necessary that he pay back the sum of $700.00, which he did.		

C's capital account is now in balance. The cash balance amounts to $12,700.00. This sum must be divided between A and B in accordance with their net investments at this time.

A Capital.........................	$8,100.00	
B Capital.........................	4,600.00	
Cash.....................		$12,700.00
A and B withdrew an amount equal to the balance of their capital accounts, thereby completing the dissolution of the business.		

If C had been insolvent, and it was found impossible to collect from him the excess withdrawal of $700.00, the loss should be shared by A and B equally as per partnership agreement.

Profit and Loss................	$700.00	
C Capital.................		$700.00
To set up loss resulting from insolvency of C.		
A Capital.....................	$350.00	
B Capital.....................	350.00	
Profit and Loss............		$700.00
To distribute loss resulting from C's insolvency, A and B sharing equally.		

After adjusting the loss of $700.00, A's net investment will be found to be $7,750.00 and B's $4,250.00. The net cash amounting to $12,000.00 would have to be distributed to A and B on the basis of their net investments.

A Capital	$7,750.00	
B Capital	4,250.00	
Cash		$12,000.00

To distribute the remaining cash balance of $12,000.00 between A and B on the basis of their present investments; A's present investment being 31/48 and B's 17/48 of the total investment.

The one in charge of the dissolution could not be held responsible for the loss due to C's overdrawing his account, because it was not in the form of an overpayment of a liquidating dividend. The loss was due to the fact that C was permitted to withdraw a sum out of proportion to his investment, and when the operating loss and loss incident to the sale of the business was charged to his drawing account, the total was greater than his investment.

Proposition B.

The following problem, taken from a recent examination held by the American Institute of Accountants, is given to demonstrate the accounting in connection with a series of liquidating dividends.

"The capital of a partnership is contributed as follows:

A	$90,000.00
B	45,000.00
C	15,000.00

A's salary is $5,000.00, B's, $3,000.00, and C's, $2,000.00 per year.

At the end of the first year's business, C dies, automatically bringing about dissolution. The books are closed and the net assets of the business are shown to be $152,500.00. A and B liquidate the affairs of the partnership and distribute the remaining assets as follows:

First liquidating dividend	$42,410.20
Second liquidating dividend	74,622.30
Final liquidating dividend	31,967.50

The partnership agreement provided for profit sharing on a basis of 50% to A, 30% to B, and 20% to C.

Set up journal entries showing distribution of profits and losses and distribution of liquidating dividends. Show partners' accounts after liquidation has been completed and accounts closed."

Solution

Operating Losses. The book value of assets is shown to be $152,500.00, while the partners' capital accounts show that capital amounting to $150,000.00 has been contributed. Salaries due partners amount to $10,000.00. It is evident,

therefore, that there has been an operating loss of $7,500.00 sustained during the year. This must be divided among the partners according to agreement. (It is assumed that each partner's salary has been credited to his capital account.)

A Capital	$3,750.00	
B Capital	2,250.00	
C Capital	1,500.00	
Profit and Loss		$7,500.00
Net loss amounting to $7,500.00 distributed as per agreement; A, 50%; B, 30%; and C, 20%.		

First Liquidating Dividend. While the problem gives sufficient information to enable the liquidator to determine the total result from realization of assets, it is assumed that at the time of the first liquidating dividend this total result was not known, hence it could not be proportioned among the partners. It is customary to charge off all losses before distributing the net assets, but there is no way by which the amount of the loss sustained at the time of the first liquidating dividend can be determined, hence no adjustments can be made.

The liquidator desiring to protect himself from risk of overpaying any of the partners desires to distribute this dividend in such a manner as to reduce the capital sharing ratio of the partners to the same basis of the profit and loss sharing ratio.

Reference to the Working Sheet, illustrated on page 27, will show that the approximate ratio of the partners' net investment to the total net capital is A, 60%; B, 30%; and C, 10%; while the partners' agreement was that profits and losses were to be shared on a basis of A, 50%; B, 30%; and C, 20%.

After this first liquidating dividend of $42,410.20 is distributed, the remaining net capital will be $110,089.80. A's capital can safely be paid down to $55,044.90, which is 50% of the remaining assets. It will readily be seen that if all the remaining assets proved worthless, A's share of the loss would be 50%, or $55,044.90, which would be just equal to the amount of his net investment after the first dividend is distributed. In other words, it will be seen that it will be safe to pay A the sum of $36,205.10.

B's capital can safely be paid down to $33,026.94, which is 30% of the remaining assets. In other words, he can be paid the sum of $12,723.06.

C's capital, which amounts to $15,500.00, is already less than 20% of the remaining assets, which is $22,017.96. Since this exceeds his net investment by $6,517.96, if all remaining assets proved worthless, it will be seen that C would be indebted to A and B for $6,517.96. If C should be insolvent, A and B would be compelled to share the loss on a ratio of 50% and 30%. In other words, A would lose 5/8 and B 3/8. This contingent loss should be charged to A and B before distribution of the first dividend. A should be charged with 5/8 of $6,517.96

or $4,073.73. B should be charged with 3/8 of $6,517.96, or $2,444.23. A's balance would be $32,131.37; B's balance would be $10,278.83; hence the first liquidating dividend may be journalized as follows:

A Capital....................	$32,131.37	
B Capital....................	10,278.83	
Cash....................		$42,410.20

A liquidating dividend amounting to $42,401.20 distributed to A and B on a basis designed to reduce the capital sharing ratio of partners to the same ratio as their profit or loss sharing basis.

Second Liquidating Dividend. This dividend amounts to $74,622.30. Deducting this sum from the total remaining capital leaves $35,467.50, which would be the amount of the loss in case the remaining assets proved worthless. Distributing this contingent loss to each of the partners on the basis of 50% 30% and 20%, will result in each partner's account showing the following balance:

A..............................	$41,384.88
B..............................	24,830.92
C..............................	8,406.50

Consequently, it will be safe to distribute this dividend to the partners on the basis of the above balances, for it will readily be seen that if all remaining assets prove worthless the loss would simply be equal to the balance of each partner's account after this dividend is distributed.

A Capital....................	$41,384.88	
B Capital....................	24,830.92	
C Capital....................	8,406.50	
Cash....................		$74,622.30

To distribute a dividend of $74,622.30. This dividend establishes a capital sharing ratio between partners equivalent to their profit or loss sharing ratio; hence all future dividends may be distributed on a basis of A, 50%; B, 30%; C, 20%.

Final Liquidating Dividend. This dividend amounts to $31,967.50. Since the partners' capital accounts have already been reduced to a ratio of 50%, 30% and 20%, this ratio being the same as the profit or loss sharing ratio, it will be seen that this dividend may be distributed on the same basis, as follows:

A, 50%........................	$15,983.75
B, 30%........................	9,590.25
C, 20%........................	6,393.50

WORKING SHEET

	A		B		C		TOTAL	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Contributed Capital.........		$90,000.00		$45,000.00		$15,000.00		$150,000.00
Salaries.....................		5,000.00		3,000.00		2,000.00		10,000.00
Operating Loss..............	$3,750.00		$2,250.00		$1,500.00		$7,500.00	
	3,750.00	95,000.00	2,250.00	48,000.00	1,500.00	17,000.00	7,500.00	160,000.00
		3,750.00		2,250.00		1,500.00		7,500.00
Net Capital End of Period... (A, 59 51/61%; B, 30%; C, 10 10/61%)..........		91,250.00		45,750.00		15,500.00		152,500.00
First Liquidating Dividend..	32,131.37		10,278.83				42,410.20	
Second Liquidating Dividend.	41,384.88		24,830.92		8,406.50		74,622.30	
Final Liquidating Dividend..	15,983.75		9,590.25		6,393.50		31,967.50	
	89,500.00	91,250.00	44,700.00	45,750.00	14,800.00	15,500.00	149,000.00	152,500.00
		89,500.00		44,700.00		14,800.00		149,000.00
Remaining Net Capital......		1,750.00		1,050.00		700.00		3,500.00
Loss on Realization......... (A, 50%; B, 30%; C, 20 %)..	1,750.00		1,050.00		700.00		3,500.00	

A Capital	$15,983.75	
B Capital	9,590.25	
C Capital	6,393.50	
Cash		$31,967.50
To distribute to partners the remainder of cash after all assets have been realized upon and all liabilities liquidated.		

While this dividend is distributed in accordance with the profit or loss sharing ratio of the partners, it is only because the partners' capital sharing ratio has been reduced to the same basis; hence, the rule that distribution of capital must be on the basis of the partners' investments has not been violated.

Loss on Realization. Reference to the Working Sheet will now show a total loss on realization of $3,500.00. This must be distributed to the partners on the basis of their agreement.

A Capital	$1,750.00	
B Capital	1,050.00	
C Capital	700.00	
Profit and Loss		$3,500.00
To distribute loss on realization to partners. A, 50%; B, 30%; C, 20%.		

It is now possible to set up the capital accounts of the partners.

A

Operating Loss	$ 3,750.00	Contributed Capital	$90,000.00
First Liquidating Dividend	32,131.37	Salaries	5,000.00
Second Liquidating Dividend	41,384.88		
Final Liquidating Dividend	15,983.75		
Loss on Realization	1,750.00		
	$95,000.00		$95,000.00

B

Operating Loss	$ 2,250.00	Contributed Capital	$45,000.00
First Liquidating Dividend	10,278.83	Salaries	3,000.00
Second Liquidating Dividend	24,830.92		
Final Liquidating Dividend	9,590.25		
Loss on Realization	1,050.00		
	$48,000.00		$48,000.00

C

Operating Loss....$	1,500.00	Contributed Capital.........	$15,000.00
Second Liquidating Dividend.......	8,406.50	Salaries...........	2,000.00
Final Liquidating Dividend.......	6,393.50		
Loss on Realization	700.00		
	$17,000.00		$17,000.00

A. THEORY QUESTIONS

1. On learning of the death of a partner, what would be your duty in case you were bookkeeper for a firm of partners that has no articles of partnership? C. P. A. Ex.

2. In case of dissolution of a partnership, in what order should the assets be distributed when there are creditors of the firm and also loans by partners of the firm, besides their stipulated capital in the business, and assuming that the remaining assets after liquidation of the liabilities are insufficient to repay the capital in full, profits being divided in a different ratio from capital? C. P. A. Ex.

3. A partnership is dissolved as at January 1, both partners being in debt to the firm. Subsequently, the assets are sold at less than the book value and the liabilities are partly liquidated. The partners pay their indebtedness as of January 1.

How must the liquidating loss be adjusted as between the partners? Why? C. P. A. Ex.

4. AB and CD form a partnership known as Middale Steel Company. AB puts in $100,000.00 towards forming capital for the company, and CD, who has been a practical worker and is to devote his whole time to the business, puts in $35,000.00, and it is agreed that CD's experience be put up as substitute for his deficiency of capital. Business was conducted for five years when they agreed to dissolve. AB made claim to the $100,000.00 which he put in originally, but CD objects, claiming an equal division as partner of the whole capital.

Discuss the rights of the two parties. Can AB legally withdraw his $100,000.00? C. P. A. Ex.

5. A and B formed a partnership for the manufacture of automobile accessories, A putting in $30,000.00 and B putting in $20,000.00, all the latter had, the object being to organize a company on a basis of $50,000.00. B was considerably more experienced than A, and it was agreed that he be the real manager of the affairs of the company, although A was nominally the head of the concern. B was to share equally in the profits with

A. Later A made advances to the firm of $5,200.00. After a number of years, A and B mutually agreed to dissolve partnership. In settling, B contended his own share should be $22, 600.00. The advances had to be aid out of the capital account, there not being enough over the capital account of the company to pay the same.

(a) Is B's contention correct? Discuss fully.

(b) What is the rule as to—

(1) Debts? (3) Capital?
(2) Advances? (4) Profits? C. P. A. Ex.

B. LEGAL QUESTIONS

1. (a) In what various ways may a partnership be terminated?

(b) For what firm contracts is an outgoing partner liable? C. P. A. Ex.

2. What precautions should be taken by a partner upon retiring from the firm? Why? C. P. A. Ex.

3. What are the rules which must be observed in adjusting the accounts of partners in liquidation:

(1) As to payment of losses?
(2) As to application of assets? Inst. Ex.

4. Does the agreement between partners at the time of a dissolution, that the remaining partner assumes all the liabilities to partnership creditors, free the withdrawing partner from such liability to such creditors? State reason for your answer. C. P. A. Ex.

5. A and B are partners, A dies. The assets are found to be worth only 75% of the liabilities in liquidation. A's estate is solvent, while B's is insolvent. What are the rights of the firm's creditors against A's assets not invested in the partnership, and what are the rights of B's personal creditors as to the partnership assets? State the rule governing in such cases. C. P. A. Ex.

C. ACCOUNTING PROBLEMS

1. A and B, partners in a commercial enterprise, share profits and losses equally. At the end of five years, the partnership terminates and the Balance Sheet appears as follows:

Balance Sheet

ASSETS		LIABILITIES	
Cash	$ 5,600.00	Accounts Payable	$30,000.00
Accounts Rec.	28,000.00	Bills Payable	10,000.00
Mdse., Inventory	36,000.00	NET WORTH:	
Plant and Mach.	15,400.00	A Capital	30,000.00
		B Capital	15,000.00
	$85,000.00		$85,000.00

After studying the Balance Sheet, an offer to buy at $30, 000.00 (except cash) is accepted. Make final adjustments and closing entries and show amount each partner receives. C. P. A. Ex.

2. The firm of A & B began business on January 1, 1912, the terms of the partnership contract specifying that no interest was to be credited on investments or charged on withdrawals, and all profits or losses were to be shared equally. A invested $24,000.00 and B $15,000.00.

On November 30, 1914, the partnership was dissolved, and as the books had not been properly kept, the following statement was submitted to the partners as a basis for settlement and agreed to by them: Cash, $14,200.00; net debit of A, $6,300; expenses, $15,300.00; net credit of B, $10,500.00; profit and loss, debit, $9,000.00, credit, $1,500.00; real estate having an estimated market value of $3,300.00; the bank holds firm's six months' 6% note for $10,000.00, due January 31, 1915, on which interest is unpaid. B liquidated the assets and liabilities and in due course sold the real estate for $4,000.00 and paid off the note when due.

Prepare the partners' accounts as of November 30, 1914, and as of the close of liquidation, and a Balance Sheet as of November 30, 1914.

C. P. A. Ex.

(**Note.** The problem does not indicate definitely whether the balances of A's and B's accounts represent their capital or drawing accounts. It might be solved on a basis of either assumption. However, it is best to assume that reference is to the partners' capital accounts. The date of the close of liquidation is not given, but January 31, 1915, may be assumed as the proper date.

An analysis of the application of the resources of the partnership from January 1, 1912, to November 30, 1914, indicates an excess application of $2,900.00. This would seem to indicate that the Cash account had been overdrawn by this amount. In reality, however, the problem shows a cash balance of $14,200.00. Accepting this as true, it is evident that resources of $17,100.00 ($14,200.00 + $2,900.00) were received from profits on sales. On these assumptions, the net loss to be distributed to the partners' accounts at the date of dissolution, November 30, 1914, is $5,900.00.

Between November 30, 1914, and January 31, 1915 (assumed to be the date at close of liquidation) there was a gain on Real Estate of $700.00. Interest on the note at the bank amounted to $100.00; hence there was a net gain of $600.00.)

3. A, B and C are in partnership, A's capital being $90,000,00; B's, $50,000.00; and C's, $50,000.00. Their agreement is to share profits or losses in the following ratio: A, 60%; B, 15%; C, 25%. During the year C withdrew $10,000.00.

Net losses during the year were $15,000.00 and it is decided to close out the business.

It is uncertain how much the assets will ultimately yield, although none of them are known to be bad.

The partners, therefore, mutually agree that as the assets are liquidated, distribution of cash on hand shall be made monthly in such manner as to avoid, so far as feasible, the possibility of paying to one partner cash which he might later have to repay to another.

Collections are made as follows: May, $15,000.00; June, $13,000.00; July, $52,000.00. After this no more was collected.

Show the partners' accounts, indicating how the cash is distributed in each installment based on the above agreement.
C. P. A. Ex.

4. A, B, and C formed a partnership. A agreed to furnish $10,000.00, and B and C each $7,000.00. A was to manage the business and receive one-half of the profits; B and C were each to receive one-fourth. A supplied merchandise worth $8,500.00, but no additional cash. B turned over to A, as managing partner, $9,000.00 cash, and C turned over $5,500.00.

The business was conducted by A for some time, but without keeping exact books. While managing the business, A purchased additional merchandise amounting altogether to $75,000.00 and made sales of $100,000.00. The cash received and paid out for the partnership was not kept separate from A's personal cash.

In order to straighten out matters, B took over the management. He found receivables amounting to $20,000.00, and of these he collected $4,500.00. The merchandise still on hand he sold for $500.00. These receipts he deposited in a bank to the credit of the firm. The remaining accounts proved worthless. The outstanding accounts payable amounted to $2,000.00 of which $1,500.00 had been incurred in purchasing merchandise and $500.00 for expenses. These accounts he paid. A presented vouchers showing that during his management he had paid other expenses of $2,400.00. By mutual agreement B was held to be entitled to $100.00 on account of interest on excess capital contributed, and A and C were to be charged $75.00 each for shortage in contribution of capital.

(a) Draft adjusting and closing journal entries; set up Profit and Loss account and accounts of each of the partners.

(b) Show how the above final adjustment would be modified if A proved to have no assets or liabilities outside the partnership.
Inst. Ex.

Chapter Three

PARTNERSHIP ACCOUNTING

1. ACCOUNTING THEORY

Financial Embarrassment. It not infrequently occurs that a partnership* will become financially embarrassed. This does not necessarily mean that the partnership is insolvent. It may mean that the assets are in some manner tied up, that it cannot meet current obligations, such as taxes, pay rolls, notes, etc., maturing at the present time.

If a firm is unable to meet its current obligations, yet is solvent and wishes to avoid bankruptcy proceedings, there are two possible courses of procedure open.

First: It may make an assignment with the consent of creditors. It must be remembered that an assignment is always made in favor of the creditors and with their consent. If a firm attempts to make an assignment without the consent of creditors, they may immediately bring bankruptcy proceedings. The assignee is appointed by the concern itself for the benefit of creditors.

Second: It may appear in a court of equity and seek the appointment of a receiver known as a "receiver in equity."

Regardless of whether the firm desires to make an assignment or whether they seek the appointment of a receiver in equity, creditors are entitled to a statement showing the financial condition of the debtor. Likewise, the court will require a report showing the financial condition. In this country, no standard form of statement is specified by the courts. However, the appointment of a receiver is looked upon by the courts of equity as an extreme measure to be resorted to only after the courts are convinced that such action is essential to a proper readjustment of finances and eventual liquidation. The court will not appoint a receiver unless the referee in the case finds one or more of the following conditions existing:

First: If the firm claims to be solvent, it must be apparent that insolvency is so evident that there may not be a proper realization of assets for the benefit of the creditors.

Second: If the firm is insolvent and creditors bring bankruptcy proceedings, (a) that they have some right or lien upon the property of the debtor; (b) that they have a legal right to consider the property of the debtor as a fund which may be used to satisfy their claims: or (c) that the debtor has fraudulently secured title or their possession to the property in litigation.

Bankruptcy. As has already been shown, a firm is insolvent when the value of the assets is less than the amount of the gross liabilities. When such a condition exists, the concern

*While this discussion of bankruptcy is included under the head of partnership accounting, the principles set forth are, in most instances, applicable to individuals and corporations as well as partnerships.

may seek voluntary bankruptcy proceedings, or the creditors may seek involuntary bankruptcy proceedings. In either event, the procedure is practically the same. The court appoints a receiver in bankruptcy. The receiver is charged with the protection and care of the property of the debtor until such time as the creditors can meet and appoint a trustee. It will be noted that the duties of the receiver in bankruptcy are, in this respect, different from the receiver in equity. The receiver in bankruptcy does not continue business operations nor does he proceed to realize upon the assets and to liquidate the liabilities. He simply cares for the property. With the consent of the court, a receiver in bankruptcy may realize on perishable assets to prevent loss thereon. He is not permitted, however, to dispose of any of the assets without the consent of the court. In fact, the work of the receiver is entirely dependent upon his instructions from the court.

As soon as a trustee has been appointed by the creditors, he will immediately proceed to dispose of the assets and to liquidate the liabilities. When such realization and liquidation has been completed, or probably at intervals during the process of realization and liquidation, the trustee may be required to render a statement of operations to the court. Such a statement has generally become known as a Realization and Liquidation Statement.

Trustee In Bankruptcy. H. C. Bentley, C. P. A., in his Science of Accounts, has described so well the appointment and duties of the trustee in bankruptcy that we can do no better than to quote from him.

"When an individual, partnership, or business corporation has been adjudged a bankrupt, the creditors at their first meeting after the adjudication should appoint one or more trustees, as may be required. In case they do not exercise this privilege, the court will appoint the trustee. The first meeting referred to above must be held not less than ten nor more than thirty days after the adjudication, at the county seat of the county in which the bankrupt had his principal place of business.

"The trustee in bankruptcy must account for all moneys belonging to the bankrupt concern which may be received by him; collect and reduce to money the property of the bankrupt; deposit all moneys received by him as such trustee in a bank designated by the court; disburse the funds only by check; lay before the final meeting of the creditors detailed statements of the administration of the estate; make final reports and file final accounts with the referee fifteen days before the day fixed for the final meeting of the creditors, and pay dividends within ten days after they are declared by the referee. He must also report to the court, in writing, the condition of the estate and the amount of money on hand, together with such other details as may be required by the court, within the first two months after his appointment and every two months thereafter, unless otherwise ordered by the court.

"It is customary for the trustee to compile, or have compiled, a Statement of Affairs and a Deficiency Statement as soon as possible after his appointment. From these two statements the court, the trustee, and any other persons at interest, may gain a fair idea of the probable results from liquidation. It is not compulsory on the part of the trustee to have such statements compiled, but it is usually done as a matter of good practice.

"The only statement actually required by the court must be furnished by the bankrupt himself within ten days after the adjudication if an involuntary bankrupt, and with the petition if a voluntary bankrupt, and consists of a schedule of his property, showing the amount and kind of property, the location thereof, and its money value in detail; a list of creditors with their addresses, the amount due each of them, the consideration thereof, the security held by them, if any; and a claim for such exemptions as the bankrupt may be entitled to. This report must be rendered in triplicate."

Statement of Affairs. In C. P. A. examinations, the Statement of Affairs has been playing quite a prominent part. It can readily be seen that such a statement is of great value to creditors at the time of assignment or of the appointment of a receiver. The receiver is usually given expressed or implied authority to employ an accountant to prepare a statement of the business, and in some cases a Balance Sheet audit is made. Appraisers are often employed to determine the realizable value of assets. Creditors may then ascertain not only the book value of assets and the gross liabilities, but may learn the expected realization. The statement shows the assets and liabilities as they appear on the books of the debtor. In addition to this information, it also shows the estimated or appraised value of assets, the amount of the preferred claims, and the amount of secured and unsecured liabilities. Naturally, preferred claims and secured liabilities must be liquidated first, consequently unsecured creditors must depend upon the remaining balance for settlement of their claims.

A Statement of Affairs, properly prepared, will give all of this information, and will show the amount of the insolvency or deficiency. A firm is insolvent only when the realizable value of assets is less than the gross liabilities.

It must be remembered that in a partnership, the personal property of each partner is, in reality, assessable for the satisfaction of firm creditors. Therefore, in preparing a Statement of Affairs for a partnership it may be advisable to include a list of the personal assets of the partners.

The Deficiency Account. This account is similar to the Profit and Loss account of a going concern. It is prepared in order to explain the causes and reasons for the estimated deficiency as shown in the Statement of Affairs. It begins with the balance of surplus as shown on the books of the concern, and to this is added all sources of profit that increase the amount

to be accounted for. All expenditures of the firm are charged to the account as are all losses incurred by it. The balance of the account shows the same amount of deficiency as is shown by the Statement of Affairs. In other words, the Deficiency account might be said to be a schedule designed to explain the amount of deficiency shown in the Statement of Affairs.

Realization and Liquidation Statement. This is a statement designed to show the operations of the trustee. It may be subdivided into:

(1) A Balance Sheet showing the book values as appearing on the books of account of the bankrupt concern.

(2) A statement showing liabilities liquidated and assets realized upon.

(3) An operating statement showing losses and gains from realization.

(4) Assets not realized upon and liabilities not liquidated.

The only difference between such a statement prepared by a trustee and one prepared by a receiver in equity is that the receiver in equity continues to operate the business, consequently he acquires new assets and incurs additional liabilities. These, of course, must be added to the original assets and liabilities, for they must be accounted for.

Receivership Accounting. The accounting for receivers in bankruptcy is very simple, as the receiver is appointed only temporarily and does not operate the business, neither does he proceed with the liquidation. He simply holds the assets until a trustee is appointed by creditors.

Accounting for a trustee in bankruptcy, while somewhat more complex than the accounting for a receiver in bankruptcy, is less complex than accounting for a receiver in equity. The trustee proceeds at once to realize on the assets and to liquidate the liabilities. Often the trustee keeps account of receipts and disbursements only.

Accounting for the receiver in equity depends entirely upon the extent and nature of the business in the hands of the receiver. However, it is no more complex than the accounting for the same concern under normal operation. The accounting for receiverships may be considered from the following standpoints:

(1) Opening the receiver's books of account.

(2) Accounting for administration of properties by the receiver.

(3 Statements to be rendered to the court.

(4) Closing the receiver's books of account.

(5) Accounting for the concern in the hands of the receiver.

Opening the Receiver's Books of Account. Since a receiver in equity is appointed by the court, and must render a full account of his operations to the court, he must, of necessity, keep his accounts in such form as to enable him to render proper statements showing the results of his operations.

The extent of the accounts of the receiver will depend very largely upon the specific instructions of the court. The receiver is frequently given control of only a part of the property; possibly only the current assets. It is not often that he is instructed to take possession of the fixed assets nor to assume the liabilities, though he may be instructed to pay a part or all of the liabilities incurred prior to his appointment. The assets taken over and the liabilities assumed may be journalized by debiting the assets, crediting the valuation reserves and liabilities, and crediting the concern for the balance. To illustrate: Assume that A is appointed receiver for B and C and the instructions of the court order him to take over the following assets:

Accounts Receivable	$1,000.00	
Less Res. for Doubt. Accts.	200.00	$ 800.00
Merchandise		2,000.00
Notes Receivable		2,000.00

The receiver opens accounts with each of the assets taken over, credits the reserve account with the amount of the reserve set up on the books of the partnership, and credits "B and C, Partnership," for the difference.

The following will serve to illustrate the proper journal entry on the books of "A, Receiver," for the facts given above:

Accounts Receivable	$1,000.00	
Merchandise	2,000.00	
Notes Receivable	2,000.00	
Res. for Doubtful Accounts		$ 200.00
B and C, Partnership		4,800.00

Accounting for Administration of Properties by Receivers. After the books of the receiver have been properly opened, the accounting for the administration of properties is very similar to the accounting for the partnership under normal operation. He must account for all transactions. The assets acquired and liabilities created through his operations must be carefully recorded in such a way that they may not be confused with assets and liabilities with which the receiver is not charged nor concerned. In some cases, the receiver keeps only a record of the cash receipts and disbursements. Usually, however, this is not sufficient. A complete set of books should be kept, showing all transactions in detail.

The accounts kept by the receiver should be uniform as nearly as possible with those previously kept by the partnership. Even in cases where systems of accounts previously in operation have been found to be defective, it is advisable to

arrive at the results in such a manner that old and new figures can be expressed, broadly speaking, in the same terms. The failure to do this, or the failure to provide for exhibiting as great a degree of detail in the accounts as has been done before, may prove embarrassing at a time when it is desired to submit the accounts for a number of years to prospective purchasers or to bankers for preliminary consideration before investigation with view of extending credit.

The accounts of the receiver should be closed at regular intervals and upon the same dates as the accounts of the partnership were closed previously. The object of this is to enable the receiver to render statements on the same dates as heretofore.

Statements to be Rendered to the Court. The first report required by the court will be a statement supported by schedules showing the properties taken over and the liabilities assumed, the liabilities being properly classified as to preferred claims, secured, unsecured and contingent liabilities. The court will require subsequent reports from time to time or, at least, annually. A Statement of Affairs is usually the first report to be submitted. It is prepared at the beginning of the receivership. Realization and Liquidation Statements are submitted to show results of the receiver's operations. These statements will be found illustrated hereinafter.

Closing the Receiver's Books of Account. The books of the receiver should be closed at the end of each fiscal period, closing all realization losses and profits into a Receiver's Profit and Loss account. When the receivership is brought to a close, and the business is returned to the owners, the receiver will close the remaining asset and liability accounts on his books by means of a journal entry, debiting the liabilities to be assumed by the owners and crediting the assets being returned to the owners. The difference will constitute a debit to the concern. This entry is practically the reverse of the opening entry at the time the receiver is appointed.

Accounting for the Concern in the Hands of the Receiver. As soon as the receiver is appointed and takes charge of the business, an account with him should be opened in the general ledger, and he should be charged for the assets taken over and the liabilities assumed.

The customary plan is to charge the receiver with assets at book value less the valuation reserves set up, and to credit him with the liabilities at book value. Another plan is to charge the receiver with the assets at expected-to-realize values, and credit him with the liabilities at expected-to-rank values. If the latter plan is followed, the difference between the book values and the realization and liquidation values should be closed into the Profit and Loss account. This is faulty because it anticipates a profit or loss that may vary widely from the actual results of the receiver's operations.

The method used by the receiver in opening his books should be followed by the bookkeeper of the concern. Using the same illustration as that shown in explaining the opening entry of the receiver, the journal entry on the books of the concern would be as follows:

Reserve for Doubtful Accounts....	$ 200.00	
A, Receiver......................	4,800.00	
Accounts Receivable.........		$1,000.00
Merchandise................		2,000.00
Notes Receivable............		2,000.00

It will be seen that this entry closes those accounts on the books of the partnership that are taken over by the receiver.

2. COMMERCIAL LAW

"The Congress shall have power to establish uniform laws on the subject of bankruptcy throughout the United States."
—U. S. Constitution, Article 1, Section 8, Paragraph 4.

Congress was given the constitutional right to pass uniform laws covering bankruptcy. Under this authority, the Congress of the United States has passed several different laws. The law in force at the present time was approved July 1, 1898. Since that time there have been several amendments.

This does not prohibit the states from enacting legislation concerning bankruptcy, but any state insolvency or bankruptcy law must not be in conflict with the Federal law.

Bankruptcy Courts. Original jurisdiction in bankruptcy proceedings rests with the district courts of the several states, in the Supreme Court of the District of Columbia or the U. S. Court in the District of Alaska. These Courts have the authority to—

adjudge persons bankrupt;
allow or disallow claims;
appoint receivers;
take charge of the bankrupt's property after the filing of the petition;
punish bankrupts and other persons, including officers and agents of corporations for any violation of the bankruptcy act;
authorize the continuation of a bankrupt's business for a limited time by receivers or trustees, if such will be for the benefit of the estate;
close estates by approving final accounts and discharging the trustees;
reopen them when it appears they were closed before being fully administered;
discharge or refuse to discharge bankrupts as the facts may warrant.

Acts of Bankruptcy. The bankruptcy law under Section Three indicates that a person has committed an act of bankruptcy when he has:

"1. Conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, any part of his property with intent to hinder, delay, or defraud his creditors, or any of them; or

"2. Transferred, while insolvent, any portion of his property to one or more of his creditors with intent to prefer such creditors over his other creditors; or

"3. Suffered or permitted, while insolvent, any creditor to obtain a preference through legal proceedings, and not having at least five days before sale or final disposition of any property affected by such preference vacated or discharged such preference; or

"4. Made a general assignment for the benefit of his creditors, or being solvent, applied for a receiver or trustee for his property, or, because of insolvency, a receiver or trustee has been put in charge of his property under the laws of a State, of a Territory, or of the United States; or

"5. Admitted in writing his inability to pay his debts, and his willingness to be adjudged a bankrupt on that ground."

Partnerships May Become Bankrupts. A partnership may be adjudged a bankrupt either while in operation or after dissolution before final settlement has been made. When the bankrupt is a partnership, the trustee of the partnership property must keep separate accounts of the property belonging to the individual partners. The expenses of administration is paid from both classes of property (firm and individual) in such proportions as the court may determine. The bankruptcy act provides the following:

"The net proceeds of the partnership property shall be appropriated to the payment of the partnership debts, and the net proceeds of the individual estate of each partner to the payment of his individual debts. Should any surplus remain of the property of any partner after paying his individual debts, such surplus shall be added to the partnership assets and be applied to the payment of the partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be added to the assets of the individual partners in the proportion of their respective interests in the partnership."

Bankruptcy Proceedings. Bankruptcy may be voluntary or involuntary. It is voluntary when proceedings are instituted by a person or firm in its own behalf. It is involuntary when the proceedings are instituted by an outside party.

Proceedings may be instituted by any one or more of the creditors to whom the alleged bankrupt is indebted not less than $500.00 in case the total number of creditors is less than

twelve. If there are twelve or more creditors, the proceedings must be instituted by three or more creditors, and their claims must aggregate more than $500.00.

Involuntary bankruptcy proceedings may be instituted by creditors filing petition asking that the debtor be declared a bankrupt. This petition must set forth the following facts:

"1. That the debtor owes at least $1,000.00.

"2. That the debtor is insolvent.

"3. That the debtor has committed an act of bankruptcy.

"4. That the act of bankruptcy was committed within four months of the filing of the petition, except in the case of fraud, where there is no fixed time limit."

To go into voluntary bankruptcy, the debtor files the petition, indicating that he is unable to pay his debts and asking that he be adjudged a bankrupt. He also files schedules giving the names and addresses of all creditors and the amounts due them, as well as a description of his assets and their value. Creditors are then notified and served with copies of the debtor's petition. Further proceedings are the same as in cases of involuntary bankruptcy.

Assignment. A debtor who is insolvent may assign all his property to a person for the benefit of his creditors. The proceedings in making an assignment are prescribed by the state laws, consequently they vary in the different states. An assignment is not often made, because it does not enable the debtor to get a discharge from his debts. Any of his creditors may institute proceedings in bankruptcy, after which the settlement must be made in the bankruptcy court.

Receivership. After proceedings have been instituted in the Federal court located in the judicial district where the bankrupt resides or has his principal place of business, or where any property belonging to the bankrupt is located, it is customary for the court to appoint a receiver, who is given charge of the bankrupt's property until the first meeting of creditors is called.

Of course, the bankrupt may defend himself, in which case he is entitled to a jury trial before the court can pronounce him a bankrupt.

After the receiver has been appointed, the bankrupt is required to file a list of claims against him. Creditors are required to file proof of their claims. This consists of an affidavit by the creditor stating the nature and amount of the claim that is due and owing, and indicating the security, if any, he holds for him.

The receiver is appointed temporarily to preserve the property until a trustee can be elected. He does not conduct the business, but merely takes care of the goods, pays the taxes and other dues, and is permitted to employ a caretaker to look after the premises between the commencement of the action and the election of the trustees. He must give bond, and is entitled to

fees based on a percentage of the amount of property handled. He may, with the court's permission, dispose of goods of a perishable nature or goods subject to changes in style and likely to become unsalable, and deposit the money realized in a bank until such time as the trustee is elected.

3. ACCOUNTING PRACTICE

Proposition A

D. C. Brown, of the firm of Brown & Coleman, endorsed notes of P. E. Curry to the amount of $12,000.00. Through the failure of Mr. Curry to pay the same when due, D. C. Brown was called upon to meet the notes and was unable to do so. A meeting of the creditors was called to determine whether further credit should be extended, or the business liquidated. They requested that a Statement of Affairs be prepared, showing the status of the business as a liquidating concern.

The following accounts appear on the books of Brown & Coleman, as of April 30, 1920: Delivery Equipment, $3,500.00; Warehouse and Office Fixtures, $2,900.00; Inventories—Merchandise, $78,180.00; Miscellaneous Supplies, $600.00; Advances on Consignments—Inward, $2,200.00; Customers' Accounts, $71,084.00; Notes Receivable, $20,200.00; Cash in Bank, $7,353.68; Petty Cash Fund, $200.00; Unexpired Insurance, $100.00; Rent Paid in Advance, $400.00; Notes Payable, $20,000.00; Accounts Payable, $72,160.00; Notes Receivable Discounted, $20,000.00; Bank Loan, $6,000.00; Taxes Accrued, $400.00; J. M. Coleman—Capital, $35,250.46; D. C. Brown—Capital, $32,835.22; Interest Accrued on Notes Payable, $72.00.

In going over these accounts, the partners decided that the Delivery Equipment would bring $2,400.00 and the Fixtures $1,250.00; that the Inventory of Merchandise, while in good condition, would realize but $50,000.00 on forced sale, and Miscellaneous Supplies, $200.00. Of the Customers' accounts $35,000.00 were good; $23,600.00 were doubtful, but would realize 50%; $12,484.00 were bad. Of the Notes Receivable $20,000.00 were good; $200.00 were bad; Advances on Consignments—Inward, $2,000.00; $346.00 was due for wages.

From the above information, prepare a Statement of Affairs and a Deficiency account.

Solution

The statement appearing on the following page indicates that the net free assets amount to $109,457.68, while the amount of unsecured liabilities amount to $110,232.00; consequently if the net free assets were to be disposed of at their estimated value, there would be a shortage of $774.32. There is also found

BROWN & COLEMAN
Statement of Affairs—April 30, 1920

Book Value	ASSETS		Expected to Realize
	CURRENT ASSETS:		
$ 7,353.68	Cash		$ 7,353.68
200.00	Petty Cash Fund		200.00
20,200.00	Notes Receivable:		
	Good	$20,200.00	
	Less Notes Disc.	20,000.00	
	Bad	$ 200.00	
71,084.00	Customers' Accounts:		
	Good	$35,000.00	35,000.00
	Doubtful (50%)	23,600.00	11,800.00
	Bad	12,484.00	
2,200.00	Advances on Consignment In.		2,000.00
78,180.00	Merchandise		50,000.00
600.00	Miscellaneous Supplies		200.00
$179,817.68	Total Current Assets		$106,553.68
	DEFERRED CHARGES:		
100.00	Unexpired Insurance		
400.00	Rent Paid in Advance		
	CAPITAL ASSETS:		
3,500.00	Delivery Equipment		2,400.00
2,900.00	Warehouse and Office Fix.		1,250.00
$186,717.68	Total Assets		$110,203.68
	DEDUCT—Pfd. Creditors		746.00
	Net Free Assets		$109,457.68
	Deficiency to Creditors		774.32
			$110,232.00
$186,717.68	Total Deficiency		$ 68,860.00

Gross Liabilities	LIABILITIES		Expected to Rank
	PREFERRED CLAIMS:		
	Wages	$346.00	
$ 400.00	Taxes	400.00	
	Deducted per contra	$746.00	
	SECURED CREDITORS:		
20,000.00	Notes Rec. Disc.	$20,000.00	
	UNSECURED CREDITORS:		
20,000.00	Accounts Payable		$ 72,160.00
72,160.00	Notes Payable		20,000.00
6,000.00	Bank Loan		6,000.00
72.00	Interest Accrued on Notes Payable		72.00
	Accommodation Paper of D. C. Brown		12,000.00
$118,632.00	Total Liabilities		$110,232.00
	Deficiency to Creditors		$ 774.32
	Deficiency to Partners:		
35,250.46	J. M. Coleman		35,250.46
32,835.22	D. C. Brown		32,835.22
$186,717.68			$ 68,860.00

to be a deficiency to partners of $68,860.00. This consists of the partners' individual investments plus the amount of the deficiency to creditors.

The deficiency to creditors may be collected from either or both of the partners. If one of the partners is insolvent the entire amount might be collected from the other partner. Even though both partners have personal assets that are assessable, the creditors may collect the entire deficiency from one of the partners, leaving the partners to settle the matter between themselves.

If desired, the personal assets of the partners might be listed among the assets in the Statement of Affairs. This is often done, though it is not called for in this particular proposition.

Deficiency Account

Estimated Loss on Realization of Assets:		Deficiency to Creditors per Statement of Affairs	$ 774.32
Notes Receivable	$ 200.00		
Customers' Accounts	24,284.00		
Advances	200.00	Deficiency to Partners of Capital Investments:	
Mdse., Inventory	28,180.00		
Misc. Suppl. Inventory	400.00	J. M. Coleman	35,250.46
Unexpired Insurance	100.00	D. C. Brown	32,835.22
Rent Prepaid	400.00		
Delivery Equip	1,100.00		
Fixtures	1,650.00		
Accommodation Paper Endorsed by D. C. Brown	12,000.00		
Wages Accrued	346.00		
	$68,860.00		$68,860.00

This account shows the causes as well as the amount of the deficiency. Note that this correlates with the deficiency shown on the Statement of Affairs.

Proposition B

After due consideration of the Statement of Affairs prepared April 30, 1920, the firm of Brown & Coleman decided to liquidate, and J. M. Coleman was appointed receiver for that purpose. On July 2, 1920, he reported as follows:

COLLECTIONS

Customers' Accounts	$46,000.84
Merchandise Inventory	53,001.00
Miscellaneous Supplies	200.00
Delivery Equipment	2,680.00
Fixtures	1,570.00
Advances	2,000.00

BROWN & COLEMAN, J. M. COLEMAN, RECEIVER

Realization and Liquidation Statement—July 2, 1920

ASSETS TO BE REALIZED:			LIABILITIES TO BE LIQUIDATED:		
Notes Receivable	$ 200.00		Taxes Accrued	$ 400.00	
Customers' Accounts	71,084.00		Notes Payable	20,000.00	
Merchandise Inventory	78,180.00		Accounts Payable	72,160.00	
Miscellaneous Supplies	600.00		Bank Loan	6,000.00	
Delivery Equipment	3,500.00		Interest Accrued on Notes Payable	72.00	$ 98,632.00
Warehouse and Office Fixtures	2,900.00				
Advances on Consignment, In.	2,200.00				
Unexpired Insurance	100.00		Accommodation Paper		12,000.00
Rent Paid in Advance	400.00	$159,164.00			
			ASSETS REALIZED:		
LIABILITIES LIQUIDATED:					
Notes Payable	$20,000.00		Customers' Accounts	$ 46,000.84	
Accounts Payable	72,160.00		Merchandise Inventory	53,001.00	
Taxes Accrued	400.00		Miscellaneous Supplies	200.00	
Accommodation Paper	10,000.00		Delivery Equipment	2,680.00	
Bank Loan	6,000.00		Fixtures	1,570.00	
Int. Accrued on Notes Payable	72.00	108,632.00	Advances	2,000.00	105,451.84
LIABILITIES NOT LIQUIDATED:					
Accommodation Paper		2,000.00	BALANCE—Loss on Realization and Liquidation		56,801.56
EXPENSES OF REALIZATION AND LIQUIDATION (incl. Wages Accrued..$346.00)		3,089.40			
		$272,885.40			$272,885.40
			Accommodation Paper Renewed		$ 2,000.00

DISBURSEMENTS

Taxes Accrued	$ 400.00
Notes Payable	20,000.00
Accounts Payable	72,160.00
Accommodation Paper	10,000.00
Bank Loan	6,000.00
Interest Accrued on Notes Payable	72.00
Expenses (including Wages)	3,089.40

$2,000.00 accommodation paper was renewed. The accommodation paper which D. C. Brown had endorsed was charged to his capital account.

You are asked to prepare a Statement of Realization and Liquidation.

Solution

On the preceding page appears the Realization and Liquidation Statement of the receiver. This shows the complete result of the receiver's operations in statement form.

Note that the exact loss on the realization and liquidation is $56,801.56, while the Deficiency account, prepared just before the receiver was appointed, showed an estimated loss on the realization of assets of $68,860.00. The Statement of Affairs shows that on the basis of the estimated loss, there would have been a deficiency to creditors of $774.32; consequently it is evident that, under the direction of the receiver, the realization and liquidation has been more satisfactory to the creditors than anticipated.

It will be noted that the accommodation paper amounting to $2,000.00 has been renewed. This is the only liability not liquidated, and since it is only a contingent liability it will be seen that it may not result in an actual liability Even though it should prove to be a loss, the total loss would be increased to only $58,801.56, which is less than the amount of the investments of the partners, the sum of which is $68,085.68; hence, under the direction of the receiver, the deficiency to creditors was eliminated and the assets realized not only enough to liquidate all liabilities, but there is a balance left to be divided between the partners of $9,284.12 after allowing for possible loss due to the contingent liability of $2,000.00 on accommodation paper.

A. THEORY QUESTIONS

1. Explain the difference between a Trial Balance, Statement of Affairs and Balance Sheet. C. P. A. Ex.

2. Explain the differences between a Trading account, Loss and Gain account, Manufacturing account, Deficiency account. C. P. A. Ex.

3. Define: Account Current, Account Stated, Amortization, Revenue, Working Capital, Betterment, Accrual, Hidden Reserve, Internal Check, Administration Expense. C. P. A. Ex.

4. Set up a Deficiency account, explaining the points involved. C. P. A. Ex.

5. With what accounts of a bankrupt concern would you open the books of the receiver?

State your reasons for so doing. Inst. Ex.

B. LEGAL QUESTIONS

1. Explain what is meant by "receiver in bankruptcy" and "trustee in bankruptcy," and state how and by whom each may be appointed. Inst. Ex.

2. What are the duties of a receiver of an insolvent partnership? C. P. A. Ex.

3. What is the general nature and object of the Bankruptcy Law? What is the effect of a discharge in bankruptcy? By what law is the subject of bankruptcy regulated in this country? C. P. A. Ex.

4. Mention the principal acts which constitute acts of bankruptcy.

5. (a) Is the bankruptcy act a state law or a federal law?

(b) In what year was it adopted?

(c) What are the respective functions of a Receiver, a Referee and a Trustee in Bankruptcy? C. P. A. Ex.

C. ACCOUNTING PROBLEMS

1. Adam Smith and Thomas Gray have been in business as contractors for the last six years. Each invested $63,000.00 cash, and was to receive one-half of the gain and bear half of the losses, which were as follows for the entire period:

Year 1899, Gain	$15,000.00
1900, Gain	18,000.00
1901, Gain	21,852.00
1902, Gain	1,500.00
1903, Loss	1,300.00
1904, Loss	3,000.00

Each withdrew from the business for private use $6,000.00 per year. On December 31, 1904, an assignment was made, and the assignee obtained the following information in addition to that already given, from which he proceeded to make a Statement of Affairs and a Deficiency account to be placed before the creditors:

Unsecured creditors on open account	$ 27,000.00
Fully secured creditors	6,900.00
Securities held by above consist of patents, valued at	9,000.00
Partly secured creditors	105,000.00

Securities held by above consist of railway shares, valued at	$ 60,000.00
Wages due	2,000.00
Rent due	400.00
Bills Payable	60,000.00
Book Debts (good)	3,000.00
Book Debts (doubtful) (est. worth $225.00)	800.00
Book Debts (bad), of no value	900.00
Stock-in-trade	112,500.00
Above is estimated worth	66,600.00
Plant and Machinery cost	120,000.00
Above estimated to produce	60,000.00
Office Furniture, $900.00, estimated worth	600.00
Bills Receivable under discount	10,000.00
Estimated liability of estate on above	4,000.00
Cash in bank	252.00

From the facts given above, prepare:

(a) A Statement of Affairs.

(b) A Deficiency account. C. P. A. Ex.

2. The copartnership of George L. Brown & Company, composed of George L. Brown, L. J. Henry and Fred S. Martin, is unable to meet its current obligations, and arranges a composition with creditors whereby the latter agree to accept 80% of their claims without interest. A trustee, Henry S. Smith, is appointed January 1, 1915, by mutual consent, to take charge of the business during liquidation. On that date the ledger of the partners showed the following balances: Cash, $105.00; Accounts Receivable, $10,000.00; Accounts Payable, $12,000.00; Notes Receivable, $5,000.00; Notes Payable, $5,000.00; Bonds, (owned), $5,000.00; Inventory, $13,000.00; Premium on bonds, $150.00; Real Estate, $3,000.00; George L. Brown, $5,000.00; L. J. Henry, $6,605.00; Fred S. Martin, $7,650.00.

The trustee continued trading for six months, his transactions summarized being as follows: Purchases, $8,000.00; salaries, $2,000.00; general expenses, $1,000.00; all paid in cash. Sales, $24,000.00; cost of sales, $16,000.00; cash received on realization, $19,250.00; cash disbursed in liquidation, $14,100.00; cash received in trading (sales), $12,000.00; cash disbursed in trading as above, $11,000.00.

The notes receivable realized face value; accounts receivable were assigned to a banker at 10% discount. The bonds were sold at 105 flat. The notes payable were paid as agreed, and the accounts payable were liquidated with the exception of one claim of $2,000.00 unsettled pending an old adjustment for damaged goods. Inventory at end of six months, $5,000.00; expenses of trusteeship, $2,100.00.

To show the results of the trustee's handling of the business, prepare Realization and Liquidation statement, Deficiency account, Cash account, and Balance Sheet at termination.

C. P. A. Ex.

Chapter Four

CORPORATION ACCOUNTING

1. ACCOUNTING THEORY

Corporate Transactions. Accounting for corporations differs from the accounting for individuals and partnerships only in connection with the strictly corporate transactions. Entries for the authorized capital stock, capital stock subscriptions, capital stock issued, capital stock transferred, organization expenses, bond issues, dividends, surplus, etc., are typical of the corporate form of organization.

Corporate Records and Books of Account. There are certain records and books of account peculiar to the corporation and necessary in order to properly record the corporate transactions. In some states the law requires that certain records of stock outstanding shall be kept. Usually the only records actually required are those relating to stock transfers, such as a stock certificate book, transfer journal and a stockholders' ledger.

Subscription Register. If there are but a few subscribers to capital stock, a proper record may be made in the corporation journal in connection with the subscription entry, but where there are many subscribers and subscriptions to capital stock are made over a comparatively long period of time, it is best to provide a subscription register in which may be recorded the names and addresses of subscribers, the amount of their subscriptions, and terms of payment.

Subscription or Installment Ledger. Where there are many subscribers and the stock is to be paid for on a payment or installment plan, it is best to keep a subsidiary ledger for accounts with subscribers. If there are only a few subscribers, accounts with them may be opened in the general ledger. Whether accounts with subscribers are opened in the general ledger or in a subsidiary ledger, they should be charged with subscriptions to capital stock as shown by the subscription register. Of course, the entry is posted from the journal and not from the subscription register. The subscription register is not a posting medium, but is an auxiliary record.

The controlling account in the general ledger for subscriptions to capital stock may be termed "Subscriptions to Capital Stock." This account controls the subscription or installment ledger. The total of the debits of the controlling account will be equal to the total subscriptions made and charged to the subscribers' accounts in the subscription or installment ledger.

Stockholders' or Stock Ledger.* This is a subsidiary ledger controlled by the Capital Stock account in the general ledger. Some bookkeepers confuse this ledger with the subscription or installment ledger. It must be remembered that the subscription or installment ledger contains personal accounts with the subscribers to the capital stock; these accounts being debited with the amount of the subscriptions and credited with payments thereon. The stockholders' ledger contains accounts with the stockholders (not subscribers), and it is intended as a record of outstanding or issued capital stock.

Each stockholder's account in this ledger should show the amount of stock actually issued and held. The accounts are credited with the amount of stock issued and debited with stock transferred, so that the balance of the accounts represents the amount of stock owned by the stockholders.

Stock Certificate Book. This is an auxiliary book made up of blank stock certificates and stubs. When a certificate is issued, the stub should be carefully filled in giving all the information desired. Subscribers may be required to acknowledge receipt of stock by signing the stub. When certificates are canceled, it is not uncommon in practice to paste the canceled certificate to the stub.

Transfer Register. When a stockholder sells or transfers a part or all of his stock, the one who acquires title to the stock should have the stock transferred on the books of the issuing corporation. Usually only a memorandum entry for transfers is made in the corporation journal, although, if desired, a special transfer register may be kept. These transfers affect only the accounts with stockholders in the stockholders' ledger, and do not in any way affect the Capital Stock account or any other account in the general ledger unless the stock is being transferred back to the issuing company as donated or treasury stock, or is being converted or canceled. As long as the transfer of stock does not affect the amount or class of stock outstanding, no accounts in the general ledger are affected.

Minute Books. Minute books are usually kept for the purpose of recording minutes of the meetings of directors and stockholders. Any ordinary blank book may be used for this purpose, as the secretary simply records the proceedings in the usual way. Sometimes the minutes are recorded in the corporation journal.

Dividend Book. Sometimes a dividend book is kept. A complete record of the dividends declared and paid is entered therein. No special form is in use and seldom is a special book kept, the usual plan being to simply record dividend transactions in the corporation journal and cash book.

*Both terms are used. It would seem better practice to use the term "Stockholders' Ledger" as the term "Stock Ledger" may be confused with a subsidiary ledger kept in connection with book inventories of finished stock, the record of finished stock sometimes being termed a "Stock Ledger."

Bond Register. When bonds are issued, a register may be used for recording the bonds issued. It is similar to a stockholders' ledger, and is designed to keep a record of and to show the amount of bonds sold and outstanding and by whom they are held.

A combination book, or corporate record, bound or loose-leaf, is used by most corporation officials, and may be purchased at the leading book and stationery stores. This book usually provides space for the Certificate of Incorporation, by-laws, minutes of the directors' and stockholders' meetings, subscriptions to capital stock, capital stock issued and transfers, and a record of the stockholders' accounts.

For illustration of special ruled corporate books, see pages 58 to 61.

2. CORPORATION LAW

Definition. In a Supreme Court Decision,* a corporation has been defined as "An association of individuals united for some common purpose, and permitted by the law to use a common name, and to change its members without dissolution of the association."

A corporation is an artificial being composed of individuals known as stockholders, yet entirely separate and distinct from its stockholders. It is created under the laws of the state in which it is organized for an expressed purpose, combining the capital for the mutual benefit of the stockholders.

Formation. Its formation is different from that of a partnership. A partnership is formed by contract or agreement, either expressed or implied, between partners, but a corporation is created by the state in which it is organized and in accordance with the laws of that state. Persons desiring to incorporate must secure a charter from the state as provided by law. This charter bestows upon a corporation the powers specified in the application for a charter. It usually shows the name of the corporation, its object and purpose, amount and classes of capital stock authorized, place of business, and term of existence. In addition to these specified powers, certain general powers are conferred, whether specified or not.

The general powers implied are:

(a) To use a corporate seal.
(b) To buy, hold, and sell real property.
(c) To appoint officers.
(d) To make by-laws.
(e) To dissolve itself before expiration of term of existence.
(f) To sue and be sued.
(g) To do all legal things necessary to carry out the expressed purpose for which it was organized.

*108 U. S., 317,330.

Advantages of Incorporation. There are certain well-defined advantages in the corporate form of organization which naturally account for the great popularity of this form of business organization.

1. Sufficient Capital More Easily Secured. The sale of stock to outside investors offers an attractive investment for both the small as well as the large investor. Certain investors would be willing to risk a definite sum, small or large, in a corporation, but would not be willing to assume the risk incident to an interest in a partnership. The rights and liabilities of officers and stockholders being fixed by law, shares may be purchased without an indefinite or uncertain liability and without the necessity of the stockholder becoming identified with the management in any way if undesirable.

2. Permanence of Organization Insured. A partnership may be dissolved at any time by the death, insolvency, or incapacity of a partner, or even by a partner desiring to withdraw, as one cannot be forced to remain a partner against his wishes. A corporation is said to possess a continuous life without regard to changes in the ownership of the capital stock. It continues to exist for the term of existence specified in the charter, regardless of changes of the stockholders.

3. An Improved Organization With Better Management. The authority and duties of the officers and directors of a corporation are clearly defined. A corporation is managed by a board of directors chosen by the stockholders who in turn appoint the officers. The directors meet periodically and outline the general policies of the company. Officers are given definite powers and authority, and are responsible to the board of directors. The board of directors is responsible to the stockholders, who meet at least annually to review the results of operation, success of the management, and elect new directors or re-elect old ones for another term. Thus, it is seen, that if an officer proves inefficient or unsuccessful, he may be dispensed with. If the work of the directors is not satisfactory to the stockholders, new directors will be selected. In a partnership there may be dissatisfaction over the conduct, services, or ability of a partner, yet it is not a simple matter to determine upon a remedy. In a corporation business may be conducted only with the duly qualified officers; persons who are simply stockholders do not possess power to transact business with outsiders. A partner is an agent of the partnership and, as such, may transact business in the name of the firm, thus binding the other partners.

4. Stockholders May Dispose of Stock at Will. While a partner cannot dispose of his interest without the consent of the other partners, a stockholder may sell his stock to whom and when he pleases. A partner cannot pledge his interest as security for his personal benefit. A stockholder may do so at will, the corporation having no voice in the matter, neither will

it be affected. This is an advantage of considerable magnitude, under certain circumstances, to the investor.

5. Liability of Stockholders Limited. The liability of a stockholder, except in certain cases, is limited to the amount of his investment which is the par value of the stock he holds or has subscribed for. A partner's liability extends beyond his investment and includes his personal holdings or wealth. A subscriber or holder of the capital stock of a bank is liable for double the amount of the par value of his stock. However, a stockholder's liability is always limited, while the liability of a partner is usually unlimited.

Disadvantages of Incorporation. It is true there are many advantages in the corporate form of organization, but at the same time there are certain well-defined disadvantages.

1. Powers Limited or Restricted. The powers of a corporation are limited to those specified in the charter. In some states (Illinois, for example), a corporation cannot deal in real estate, neither can it purchase or hold stock in another corporation. An individual or partnership possesess the power or right to do anything that is legal and not forbidden by law, but a corporation is given authority to do only those things expressly permitted under the law.

2. Credit May be Limited. A corporation may be unable to secure as much credit as a partnership. Since stockholders are not responsible financially beyond the par value of their stock, it can readily be seen that the credit rating of a corporation may be much less than the credit rating of a similar concern organized as a partnership. Hence, if a corporation desires a certain amount of credit, it may be necessary for one or more of the officers to endorse company notes assuming personal liability thereon.

3. Taxation and Supervision. Many burdens have been and are being imposed on the corporation, such as government (state and federal) requirements as to reports, fees, taxes, etc. The Income Tax laws have been the cause of many corporations dissolving and reorganizing in the form of a partnership, due to the fact that in many instances the law seems to be unfair to the corporation as compared with the partnership. (This will become more evident in a later study to be made of the Income Tax laws and their application.)

Incorporators. The parties who file application for a charter or certificate of incorporation are known as the incorporators. Such parties must be competent to contract, a part or all must be citizens of the state in which application for charter is filed, and usually each incorporator is required to be a subscriber for one or more shares of the capital stock. The incorporators must all sign the application for the charter.

Application for Charter. The application for a Certificate of Incorporation or charter must be signed by the incorpo-

Certificate of Subscription

To the Secretary of State, Columbus, Ohio:

We, the undersigned incorporators of The ....

Company, do hereby certify that on the ...... day of ....,

192.., all the incorporators of said Company did order, in writing, that books be opened for subscriptions to the capital stock of said Company,

at .... on the .... day of ....,
(City)

192.. at ...... o'clock, ... M.; and, at the same time, waive, in writing, the notice by publication of the time and place of such opening of books of subscription, required by law; and, further, said books having been opened at the time and place ordered, that ten per cent. of the capital stock of said Company has been subscribed.

....
Incorporators.

Note—Fee for filing Certificate of Subscription $2.00.

These Articles of Incorporation
OF

The.................................Company

WITNESSETH, That we, the undersigned, ... of whom are citizens of the State of Ohio, desiring to form a corporation, for profit, under the general corporation laws of said State, do hereby certify:*

FIRST. The name of said corporation shall be The ....

.. Company.

SECOND. Said corporation is to be located at ....
(City or Town)

.... in .... County, Ohio, and its
(Street Number)
principal business there transacted.

THIRD. Said corporation is formed for the purpose of ....

..

FOURTH. The capital stock of said corporation shall be ....

.... Dollars ($..........), divided into ....

(..........) shares of .... Dollars ($...........) each.

IN WITNESS WHEREOF, We have hereunto set our hands, this

.... day of ...., A. D. 19....

....
(Name) (Address)

*"all" or "a majority."

rators and filed with the Secretary of State or other designated officer. The legal requirements vary in the different states.

The Ohio law requires that the corporation must file Certificate of Subscription and Articles of Incorporation. (See illustrations on opposite page.) The Articles of Incorporation must be subscribed by at least five persons, the majority of whom must be citizens of Ohio. They may be acknowledged before any officer who is authorized to take acknowledgments of deeds, and the official character of the officer taking such acknowledgment must be certified to by the Clerk of the Court of Common Pleas of the county in which the acknowledgment is made. Subscription books must be opened, and at least 10% of the capital stock must be subscribed at the date of filing the Articles of Incorporation.

Stockholders. All parties holding stock of a corporation, or who have subscribed for stock and their subscription has been accepted, are known as stockholders. In order to possess all the rights of a stockholder of record, the party holding stock must have his ownership duly recorded on the books of the issuing company. If a party purchases stock from a stockholder, such stock must be transferred on the books of the issuing company before he is entitled to a certificate of stock in his own name, to vote, or to be entitled to a share in the dividend. The rights, powers, and liabilities of the common stockholders, while dependent largely upon the laws of the state and the by-laws of the corporation, may be generally summarized as follows:

(a) Rights—

1. To be notified of the annual or any special meetings and to participate in all meetings of the stockholders.

2. To cast one vote for each share of stock held, either in person or by proxy.

3. To share in the dividends declared on the common stock in proportion to the amount of common stock owned.

4. To share in any assets remaining after liquidation of all liabilities, in case of dissolution, in proportion to amount of common stock owned.

5. To examine the books and records of the corporation, though this right has practically become restricted to the right to examine the stockholders' ledger.

6. To sell the assets or property of the company.

(b) Powers—

1. To adopt and amend the by-laws.

2. To elect the board of directors.

3. To amend the Articles of Incorporation as provided by law.

4. To dissolve the company.

5. To exercise all special powers conferred by the Articles of Incorporation.

(c) Liabilities—

1. For any installments remaining unpaid upon stock subscriptions, either to the issuing company or to its creditors.

2. For the amount of the discount received on stock purchased, to the company's creditors.

3. For an amount equal to their original subscription to the stock of a national bank, and usually of a state bank or trust company, in case of insolvency of the company.

4. For dividends paid from capital instead of from earned profits, to creditors of the company.

Directors. The stockholders elect a board of directors which is charged with the management and direction of corporate affairs. It will readily be seen that it would be impracticable for all the stockholders of a large corporation to meet periodically or at special times to decide upon questions in connection with the direction and management of affairs; hence, the stockholders elect a board of directors, who are responsible to them for the proper management of the corporate affairs. The directors are held to be the agents of the corporation.

A board of directors usually consists of three or more stockholders. Where the board is composed of a large number of persons, it is customary to appoint an executive committee of from three to five members of the board, who are given authority to administer the affairs of the corporation. Of course, the executive committee is responsible to the board of directors for their actions.

Rights of Directors. Directors possess the right—

1. To manage the corporate affairs.
2. To elect the corporate officers.
3. To vote on all matters coming before the board in an official manner, each director casting one vote instead of casting a vote for each share of stock owned.
4. To declare and fix the amount of dividends.
5. To execute corporate contracts unless this right has been conferred upon the officers.
6. To examine the books of account and all records of the corporation.
7. To allot shares of stock to applicants. The board as a whole, and not a committee, possesses this power.

Liabilities of Directors. The liabilities of directors are fixed by the state statutes. They are generally held liable—

1. For gross negligence in managing the corporate affairs.
2. For selecting officers who are not qualified for the positions to which they are elected.
3. For failure to use ordinary care and exercise diligence in supervising the acts of the officers after they are selected.

4. For issuing stock as fully paid when it is not in reality fully paid.

5. For declaring dividends out of capital instead of from profits.

Officers. The board of directors appoints the officers. Usually a president, vice-president, secretary and treasurer are appointed as executive officers. Often one man holds two positions. All the officers are responsible to the board of directors and receive their instruction from the board. They have no authority whatever other than to perform the duties imposed by the by-laws of the corporation and the statutes of the state. They are generally liable for fraud or misrepresentation, or for exceeding the rights and powers conferred by the by-laws of the company or the statutes of the state.

Compensation of Officers and Directors. The general officers of a corporation, including the directors, are supposed to serve in their capacities as such without compensation. Therefore, if officers and directors do serve in this capacity only, without having received compensation, or without an agreement to the effect that they are to receive compensation, they cannot, without consent of the stockholders, be voted salaries as back pay. To do so would be to give away corporate funds. If an officer renders special service in addition to the ordinary functions of his office, there is an implied promise to pay for such service, and in cases of this kind the directors have the right to fix the amount of the compensation. As a rule, stockholders reserve the right to themselves to fix the salaries of the general officers, and they leave to the directors the right to fix the salaries of all other employes.

3. ACCOUNTING PRACTICE

Recording Corporate Transactions. Accountants are frequently asked to devise accounting systems and to open the books of the corporation at the time of its organization. While a combination corporate book, such as is described on page 51, may often be used with satisfactory results, yet, in many instances, it is advisable to devise corporate records with special rulings. In order to illustrate certain corporate records and books of account, we will assume the following transactions.

Proposition A

Transaction One. The Central Manufacturing Company was incorporated January 1, 1920, under the laws of the state of Ohio, with an authorized capital stock of $250,000.00, consisting of 2500 shares of the par value of $100.00 each. A subscription book had been opened and subscriptions to capital stock received, as shown in the illustration on page 58.

Transaction Two. January 2, 1920, following the filing of Articles of Incorporation, the subscribers to capital stock were

assessed one-half the amount of their subscriptions. Certificates of stock are not to be issued until stock is fully paid.

Transaction Three. March 1, 1920, the subscribers settle for the balance due from subscriptions to capital stock as follows:

Chas. Pratt....................	$25,000.00
H. W. Henry..................	25,000.00
J. F. Ward....................	15,000.00
L. G. Tillotson................	2,500.00

By agreement, Henry L. Hunt gives a ninety day note, with interest at 6%, for the balance due on his subscription. Stock certificates are issued.

Transaction Four. July 1, 1920, J. F. Ward sells 50 shares of his stock to J. E. O'Brien. The stock is transferred on the books of the company, and a new certificate issued to J. F. Ward for 250 shares.

SUBSCRIPTION REGISTER

THE CENTRAL MANUFACTURING COMPANY

Cincinnati, Ohio

To be incorporated under the laws of the State of Ohio with an authorized capital stock of $250,000.00, divided into 2,500 shares with a par value of $100.00 each.

We, the undersigned, hereby severally subscribe for and agree to take at par, at the terms indicated, the number of shares of the capital stock of The Central Manufacturing Company set opposite our respective signatures.

Date	Name	Address	No. Shares	Am't. Sub'd.	Terms
1920					
Jan. 1	Charles Pratt	Leavenworth, Kans.	500	$50,000	On demand
1	H. W. Henry	Canton, Ohio	500	50,000	On demand
1	J. F. Ward	Akron, Ohio	300	30,000	On demand
2	Henry L. Hunt	St. Louis, Mo.	150	15,000	On demand
2	L. G. Tillotson	Cleveland, Ohio	50	5,000	On demand

Corporation Journal. The illustration on page 59 shows an especially ruled corporation journal. If the capital stock were partly common and partly preferred, additional columns should then be ruled for the preferred stockholders' ledger, with provision for showing the number of each certificate and number of shares issued or transferred. It is assumed that proper entries for cash receipts and payments are made in the cash book. However, a memorandum entry is made in the corporation journal for all cash transactions when they constitute strictly corporate transactions.

Stockholders' Ledger. In the illustration on page 61, there is shown three accounts with stockholders. Space did not permit illustrating the accounts with all the stockholders. However, the object of the illustrations is to show the proper heading and ruling of the stockholders' ledger rather than the entries affecting the accounts therein.

CORPORATION JOURNAL

Stockholders' Ledger, Dr. No. Cert.	Stockholders' Ledger, Dr. No. Shares	General Ledger Dr.	Explanation	General Ledger Cr.	Stockholders' Ledger, Cr. No Shares	Stockholders' Ledger, Cr. No. Cert.
			Jan. 1, 1920			
		$250,000.00	Unissued Capital Stock.....			
			Authorized Capital Stock	$250,000.00		
			The Central Manufacturing Co. was incorporated this date under the laws of the State of Ohio, with an authorized capital stock of $250,000.00, divided into 2500 shares with a par value of $100.00 each.			
		150,000.00	Subscriptions to Capital Stock			
			Capital Stock Subscribed	150,000.00		
			Subscriptions to capital stock as per subscription register.			
			Jan. 2, 1920			
			Subscribers to capital stock were assessed one-half the amount of their subscriptions. By agreement no certificates of stock are to be issued until stock has been fully paid for. (See cash book for entries on account of cash received from subscribers.)			
			March 1, 1920			
		7,500.00	Note Receivable...........			
			Subs. to Capital Stock...	7,500.00		
			Henry L. Hunt settles for balance due on his subscription by giving a ninety day note with interest at 6%.			
			(See cash book for receipts from capital stock subscribers for balance due on their subscriptions.)			
		150,000.00	Capital Stock Subscribed...			
			Unissued Capital Stock..	150,000.00		
			Certificates issued as follows:			
			Charles Pratt		500	1
			H. W. Henry		500	2
			J. F. Ward		300	3
			Henry L. Hunt		150	4
			L. G. Tillotson		50	5
			July 1, 1920			
3	300		J F. Ward, Cert. canceled			
			J. E. O'Brien, Cert. issued		50	6
			J. F. Ward, Cert. issued		250	7
			J. F. Ward sells 50 shares of his stock to J. E. O'Brien.			

STOCK CERTIFICATE STUBS

CERTIFICATE No. *1*
For *Five hundred* Shares
ISSUED TO
Name *Chas. Pratt*
Address *Leavenworth, Kansas*
Dated *March 1,* 1920
FROM WHOM TRANSFERRED
Original
Dated 19

No. Original Certificate	No. Original Shares	No. Shares Transferred
1	*500*	

RECEIVED CERTIFICATE No. *1*
For *Five hundred* Shares
This *1st* Day of *March,* 1920
Signature of Stockholder *Chas. Pratt*

CERTIFICATE No. *2*
For *Five hundred* Shares
ISSUED TO
Name *H. W. Henry*
Address *Canton, Ohio*
Dated *March 1,* 1920
FROM WHOM TRANSFERRED
Original
Dated 19

No. Original Certificate	No. Original Shares	No. Shares Transferred
2	*500*	

RECEIVED CERTIFICATE No. *2*
For *Five hundred* Shares.
This *2nd* Day of *March,* 1920
Signature of Stockholder *H. W. Henry*

CERTIFICATE No. *3*
For *Three hundred* Shares
ISSUED TO
Name *J. F. Ward*
Address *Akron, Ohio*
Dated *March 1,* 1920
FROM WHOM TRANSFERRED
Original
Dated 19

No. Original Certificate	No. Original Shares	No. Shares Transferred
3	*300*	

RECEIVED CERTIFICATE No. *3*
For *Three hundred* Shares
This *5th* Day of *March,* 1920
Signature of Stockholder *J. F. Ward*

CERTIFICATE No. *4*
For *One hundred and fifty* Shares
ISSUED TO
Name *Henry L. Hunt*
Address *St. Louis, Mo.*
Dated *March 1,* 1920
FROM WHOM TRANSFERRED
Original
Dated 19

No. Original Certificate	No. Original Shares	No. Shares Transferred
4	*150*	

RECEIVED CERTIFICATE No. 4
For *One Hundred and fifty* Shares
This *5th* Day of *March,* 1920
Signature of Stockholder *Henry L. Hunt*

CERTIFICATE No. *5*
For *Fifty* Shares
ISSUED TO
Name *L. G. Tillotson*
Address *Cleveland, Ohio*
Dated *March 1,* 1920
FROM WHOM TRANSFERRED
Original
Dated 19

No. Original Certificate	No. Original Shares	No. Shares Transferred
5	*50*	

RECEIVED CERTIFICATE No. *5*
For *Fifty* Shares.
This *5th* Day of *March,* 1920
Signature of Stockholder *L. G. Tillotson*

CERTIFICATE No. *6*
For *Fifty* Shares
ISSUED TO
Name *J. E. O'Brien*
Address *Riverside, Calif.*
Dated *July 1,* 1920
FROM WHOM TRANSFERRED
J. F. Ward
Dated *March 1,* 1920

No. Original Certificate	No. Original Shares	No. Shares Transferred
3	*300*	*50*

RECEIVED CERTIFICATE No. *6*
For *Fifty* Shares
This *1st* Day of *July,* 1920
Signature of Stockholder *J. E. O'Brien*

STOCKHOLDERS' LEDGER

STOCKHOLDER'S NAME *Charles Pratt* ADDRESS *Leavenworth, Kansas.* No. *1.*

Date Transferred	To Whom Transferred	Certificate No. Old	Certificate No. New	No. Shares	Date Issued	From Whom Transferred	Certificate No. Old	Certificate No. New	No. Shares	Balance Credit No. Shares
					March 1	*Original*		*1*	*500*	*500*

J. F. Ward *Akron, Ohio.* *3*

Date Transferred	To Whom Transferred	Certificate No. Old	Certificate No. New	No. Shares	Date Issued	From Whom Transferred	Certificate No. Old	Certificate No. New	No. Shares	Balance Credit No. Shares
July 1	*J. E. O'Brien*	*3*	*6*	*50*	*March 1*	*Original*		*3*	*300*	*300*
1	*Self*	*3*	*7*	*250*	*July 1*	*Self*	*3*	*7*	*250*	*250*

J. E. O'Brien *Riverside, Calif.* *6*

Date Transferred	To Whom Transferred	Certificate No. Old	Certificate No. New	No. Shares	Date Issued	From Whom Transferred	Certificate No. Old	Certificate No. New	No. Shares	Balance Credit No. Shares
					July 1	*J. F. Ward*	*3*	*6*	*50*	*50*

A. THEORY QUESTIONS

1. What are the distinguishing characteristics of the corporation as compared with other forms of business organization? What principles does it cover, and what, if any, are its disadvantages? Inst. Ex.

2. (a) What books of record are necessary in addition to the books of account for a corporation existing under the laws of your state?
(b) Of what value would such records be for the purpose of an audit? Inst. Ex.

3. Can surplus be created in any way other than through profits earned from operations? Explain. Inst. Ex.

4. Explain fully and state how accounts should be carried upon the books with:
   (a) Authorized Capital Stock.
   (b) Unsubscribed Stock.
   (c) Treasury Stock.
   (d) Preferred Stock.
   (e) Common Stock.

5. A company has acquired, by purchase in the open market at $85.00 per share, 100 shares of its own capital stock, par value $100.00 per share. Its Balance Sheet shows "Treasury Stock, $8,500.00." Is this correct? If so, why? If not, state how you would adjust. C. P. A. Ex.

B. LEGAL QUESTIONS

1. (a) Define a corporation. (b) What general power does every corporation possess? (c) Distinguish between capital and capital stock, and explain the nature of a share of stock. (d) What are by-laws and who are bound by them? C. P. A. Ex.

2. Have directors of a corporation the right to rescind, alter or amend by-laws adopted by stockholders? If so, under what conditions? If not, why not? C. P. A. Ex.

3. To what extent may directors delegate their powers to an executive committee? Give reasons for your answer. Inst. Ex.

4. Have directors the power to vote or pay increased salaries to officers for past services rendered in the usual and ordinary course of business? Give reasons for your answer. Inst. Ex.

5. (a) What right has a stockholder to a share of the profits of a corporate business? (b) Has a stockholder a right to examine the books of a corporation? If so, for what purpose? Inst. Ex.

C. ACCOUNTING PROBLEMS

1. Frame any entries necessary to record the action of the directors as it appears in the minutes of the meeting of August 15, 1917, of which the following is a synopsis, and the action of the officers taken pursuant to authority conferred on them by such minutes:

The treasurer reported that the profits for the year as audited amounted to $59,287.00. Voted that a dividend of $40,000.00 be paid on October 1 to the stockholders of record September 15, and that $10,000.00 of the profits be appropriated as a reserve for relief of employes disabled while in the service of the United States and invested in liberty bonds.

The treasurer reported that he had an offer of $1,000.00 in settlement of a debt of $3,000.00 of the A. B. C. Company, which had been written off as uncollectible in 1914. He was authorized to accept the offer in full settlement.

The president reported that he had received tenders for new building planned in the amount of $185,000.00. He was authorized to execute a contract accordingly.

The president reported that a firm of bankers had offered to purchase $200,000.00 of the company's twenty-year five per cent. bonds to be dated October 1, 1917, at 93 and accrued interest. He was authorized to accept the offer and deliver bonds on that date. Inst. Ex.

2. As on January 1, 1905, a corporation is formed for the purpose of acquiring and conducting a cemetery, and starts business on that date with a capital stock of $100,000.00 paid for in cash. The company first purchases forty acres of land within easy access of a large city, paying for same at the rate of $1,000 per acre. It proceeds to expend considerable sums of money in the purchase and planting of trees and shrubs, laying out drives, and pathways, sodding, building of glass houses, etc. The policy of the company is to withhold the selling of burial lots until after January 1, 1915, so as to allow the trees and shrubs to become more fully grown and in the expectation that with the growth of the city their property will become more valuable.

In the year 1915, the company commences selling burial lots, and all lots are sold under a special provision whereby the company agrees to apply fifty per cent. of all cash received on sales in the purchase of four per cent. bonds until a total of $150,000.00 of such bonds shall have been so purchased. The agreement further provides that after all the lots have been sold, the company will wind up its affairs and the above bonds, amounting to $150,000.00, shall be given to the city, which shall use the income of such bonds for keeping up the cemetery. It is the custom of the company not to purchase bonds until after the close of each fiscal year and after the total sales of that year have been determined.

March, 1920, the directors of the company find that, while they believe the books to be in balance, no proper entries have been recorded showing the total cost of their investment, and that no entries have been made with respect to the fund of $150,000.00 from which said bonds are to be purchased. While cash dividends have been declared and paid, the directors are in ignorance of what their profits actually have been, and how much of the dividends so received have been out of their profits and how much in the nature of liquidating dividends representing a return of their original investment. They, therefore, employ a Certified Public Accountant to determine all these matters, and to make the necessary entries on their books, and render report to them.

After determining the clerical accuracy of the books, the accountant draws off the two Trial Balances given below, and from them prepares the necessary entries and obtains the information required by the directors.

Trial Balances

DEBITS:	Jan. 1, 1915	Jan. 1, 1920
Real Estate	$ 40,000.00	$ 40,000.00
Improvements	45,000.00	45,000.00
Bonds	....	125,000.00
Administration Expense	20,000.00	46,000.00
Upkeep of Cemetery	....	45,000.00
Dividends paid	....	130,000.00
Cash	7,000.00	40,800.00
	$112,000.00	$471,800.00
CREDITS:		
Interest account representing interest at 4% on unexpended cash during development period	$ 12,000.00	$ 12,000.00
Bond Interest account	....	9,800.00
Sale of Lots	....	350,000.00
Capital Stock	100,000.00	100,000.00
	$112,000.00	$471,800.00

An inventory of their unsold lots as on January 1, 1920, shows that they have ten acres left unsold of equally desirable character with that already sold. Draw up entries, prepare Profit and Loss account for period and Balance Sheet as on January 1, 1920, in same manner as if you had been the accountant engaged. In any interest calculation, use four per cent. simple interest. C. P. A. Ex.

Chapter Five

CORPORATION ACCOUNTING

1. ACCOUNTING THEORY

Treasury Stock. A corporation frequently comes into possession of its own capital stock. This may come about through purchase, donation or forfeiture. In some states a corporation is not allowed to purchase its own capital stock. For instance, in Missouri the law provides that a corporation may not purchase its own capital stock but may acquire it in consideration of the surrender of a past due note provided such action is clearly in the interest of the corporation. The stock thus acquired may then be sold at whatever price it will command.

Stock may be purchased when not forbidden by law. The corporation may purchase its own capital stock with possibly either of two objects in view. The object may be to reduce the amount of capital stock outstanding, thereby reducing the capital liability. This may occur at a time when the stock may be purchased at a discount. It is not likely that a corporation would purchase its own stock at par or at a premium with the object of reducing the capital liability. Another instance for acquiring its own capital stock is probably due to an arrangement with stockholders in the form of an agreement to purchase the capital stock under certain contingencies. For instance, the corporation may agree with employes to sell a certain amount of capital stock and may further agree to purchase the capital stock at an agreed valuation at any time when the holder leaves the employ of the company. In this case, the stock might be acquired at par or at a premium.

Donation Stock. Stockholders may donate a part of their holdings back to the issuing company. In some cases, there is an agreement to this effect at the time of organization, or when property is purchased at an overvaluation. The corporation may acquire a plant and agree to give the owner $100,000.00 in capital stock, common, though in reality the plant is actually worth but $75,000.00. It is agreed, however, that the owner is to donate back to the company $25,000.00 of the stock to be placed in the treasury and sold at whatever it will command, and this sum is to be used as additional working capital. It will readily be seen that action of this kind is intended to evade the law. The stock having been issued as fully paid stock and donated back to the company as treasury stock may be sold at a discount, and the purchaser thereof will not be liable either to the corporation or to the corporate creditors for the difference between the price paid and the par value of the stock. It is true that donation stock does not necessarily represent stock issued in consideration of property that

has been overvalued. It may represent stock that was actually paid in full, but the stockholders finding it advisable to raise additional working capital may agree to donate a certain part of their holdings back to the company for the purpose of raising working capital or for some other purpose.

Forfeited Stock. Subscribers may forfeit stock that has been partially paid for. A stockholder may subscribe for $5,000.00 worth of stock at par, agreeing to pay for it on an installment plan. In case he fails to meet the installments as they fall due, he may forfeit his stock, or, rather, forfeit his title to stock, for, in reality, the stock is usually not issued until it has been paid for in full.

Thus, it will be seen that a corporation may acquire its own capital stock either through purchase, donation or forfeiture, and there are certain accounting principles to be comprehended. There should be a distinction in the accounts of stock acquired through purchase, donation or forfeiture. Many accountants consider stock purchased and stock donated in the same light, classing it as treasury stock and charging it to the same account, thereby making no attempt to distinguish between stock acquired by purchase and stock donated. It would seem to be better practice to keep separate accounts for these two classes of stock. Stock actually purchased might be termed true "treasury stock," while stock donated might be termed "donation stock." Stock that has been forfeited should not be classed as treasury stock. Having never been fully paid, it cannot be sold at less than par value in most states. Furthermore, the purchaser of forfeited stock at a discount would be liable for the difference between the price paid and the par value.

Accounting for Stock Acquired by the Issuing Company Through Purchase. Authorities do not agree as to the proper method to be used in recording capital stock acquired through purchase. Some claim that such stock should be charged to Treasury Stock at cost. Some claim that it should be charged at its estimated market value. Others claim that it should be charged at par value.

Walton claims that "Treasury stock is a reduction of capital stock for the time being. In the Balance Sheet it should always be shown as such by being deducted from the total capital, thus:

Capital Stock............	$100,000.00	
Less Treasury Stock..	15,000.00	$85,000.00

"In this way the total capital is shown and at the same time the actual stock outstanding. If the treasury stock is carried in any other way than at par, this offset cannot be made, since offsetting items must be of the same character.

Premium on Treasury Stock. "If treasury stock is bought at a premium, the stockholder who sells it to the company has really sold two things—a certain number of shares of stock and his undivided interest in the surplus of the company. If the company has paid him that portion of the surplus, the proper entries to make would be a charge to Treasury Stock of the par value of the stock bought and a charge to Surplus of the premium paid.

Discount on Treasury Stock. "When its own stock is bought by a company at a discount and placed in the treasury at par, it might at first sight appear as if they had made a profit on the purchase and that Surplus should be credited with the amount of the discount. The case is not the exact opposite of the purchase of treasury stock at a premium. The premium having been paid in cash represents an actual loss to the company of a certain portion of its surplus. The discount not having been received in cash does not represent a realized profit, and unless the stock can be shown to be unquestionably worth par, it does not represent any profit at all. The proper treatment of the discount is to credit it to 'Contingent Profit on Stock,' or to some other account which will clearly indicate that it is not a real profit. When the stock is sold, the difference between par and the price realized would, if a discount, be charged, and if a premium be credited to the Contingent Profit account and the balance of that account would then be an actual realized profit or loss as the case may be."

While Walton's ideas seem to be the more sound and the more practical, it is only just to quote what Bennett, who is considered quite an authority on corporation accounting, has to say. "The Treasury Stock account should be debited with the capital stock issued by a corporation and subsequently acquired at cost of stock purchased. The account should be credited with the value at which the shares were charged to this account. The balance of the account is an asset and should represent the cost of treasury stock owned. Treasury stock differs in no wise from the other stock outstanding except that, while in the treasury, it has no vote and cannot draw dividends. The voting stock is represented by the outstanding shares less the treasury shares owned."

It will be noted that Bennett admits that the voting stock represents the difference between the outstanding stock and the amount of stock held in the treasury. However, his plan seems to be to consider treasury stock an asset to be listed as such on the Balance Sheet, while Walton considers treasury stock a deduction from the outstanding capital stock on the liability side of the Balance Sheet. While the results obtained are the same under both plans, yet it is more logical to record treasury stock at its par value. When the stock was originally issued it was recorded at par. At the time of its purchase it should,

therefore, be recorded at par also, and the difference between the purchase price and the par value should be reflected either in the Surplus account or in a Contingent Profit and Loss account.

If the stock is purchased at a premium, such premium undoubtedly represents the stockholder's share in the surplus, hence he is really paid for his stock at par, and in addition is given his share in the surplus on such stock; therefore, the amount of the premium should be charged to the Surplus account. If, on the other hand, the stock is purchased at a discount, it cannot be said that the company has acquired surplus and that the Surplus account should, therefore, be credited with the amount of the discount. Instead, the company has made a contingent profit realizable only in the event of resale of stock above its cost. Such discount should, therefore, be considered as a contingent profit and should be credited to Discount on Treasury Stock. It does not represent an earned profit available for dividends.

Accounting for Stock Donated to the Issuing Company. While it is true that donation stock is similar to treasury stock and might be so classified in the accounts, it would seem to be better to make a distinction between stock purchased by the issuing company and termed "treasury stock" in the above discussion. To accomplish this purpose, stock acquired by gift may be charged to a Donation Stock account. Since the stockholders usually specify the purpose for which the stock is being donated, this would be a consideration in determining the proper account to be credited.

If the stock donated to the issuing company represents an overvaluation of property or good will paid for by issuing original stock, such donation stock should be credited to Property or Good Will accounts, thereby reducing them to their actual value. It would be very poor practice to credit Surplus for the proceeds from the sale of donation stock and permit good will or other assets to remain on the books at an inflated value.

If, on the other hand, the assets are not inflated, and the true purpose of the donation of stock is to provide working capital, the customary procedure is to credit Donated Working Capital. Like treasury stock, donation stock should be recorded on the books at par value. At the time it is acquired, debit Donation Stock and credit Donated Working Capital. If it is subsequently sold at a discount, the Donation Stock account should be credited for the par value and the discount should be charged to the Donated Working Capital account. This can be done either directly at the time of the sale of the donation stock, or if desired, a separate account may be set up with Discount on Donation Stock, and this account can be closed into the Donated Working Capital account at the end of the fiscal period. Donation stock nearly always sells at a discount—seldom at par. The account with Donated Working Capital

will show the actual amount of working capital raised after all donation stock has been disposed of. This is clearly indicated, because this account is credited with the par value of donation stock acquired and debited with the discount on donation stock sold, consequently, the cash received from the sale of donation stock is just equal to the balance of the Donated Working Capital account after all donation stock has been sold.

The amount realized from the sale of donation stock is in reality an addition to surplus. It would not be wise, however, to credit it direct to the Surplus account and to consider it available for dividends. If it were distributed in the form of dividends, the stockholders would lose the benefit expected to accrue from the donation at the time it was made. In other words, if the surplus acquired through the sale of donation stock is distributed in the form of a dividend, the stockholders have simply sold their holdings to others and the company has not benefited in the least. Since the stock was acquired by gift and cost nothing, it will readily be seen that whatever is realized upon the sale thereof is truly a profit, but it should be considered as a permanent surplus not available for dividends. It is not infrequent that stockholders in making a donation of capital stock specify that the receipts from its sale are not to be available for dividends. Therefore, in the Balance Sheet the surplus would be shown in two divisions. Profits realized from the sale of donation stock would be stated as permanent surplus, while the earned profits from operations only would be available for dividends to be distributed subject to the action of the board of directors.

Accounting for Stock Forfeited by Subscribers. In some states the law provides that whatever installments may have been paid by the subscriber must be returned to the purchaser in case of default. In other states the law provides that a part, whether that above the expenses incurred in the handling of the transactions or a specified proportion of the amount paid in, must be returned to the purchaser; while in other states the law provides that the subscriber, in case of default in payments due on stock, forfeits all payments previously made thereon.

The law of the State of New York provides that "If default shall be made in the payment of any installment, the board may declare the stock and all previous payments thereon forfeited for the use of the corporation after the expiration of sixty days from the service on the defaulting stockholder, personally or by mail directed to him at his last-known post office address, of a written notice requiring him to make payment within sixty days from the service of the notice at a place specified therein, and stating that, in case of failure to do so, his stock and all previous payments thereon will be forfeited for the use of the corporation. Such stock, if forfeited, may be reissued or subscriptions therefor may be received as in the case

of stock not issued or subscribed for. If not sold for its par value or subscribed for within six months after such forfeiture, it shall be canceled and deducted from the amount of the capital stock."

Forfeited stock should be charged to Unissued Capital Stock rather than to Treasury or Donation Stock. Payments forfeited by the subscriber constitute surplus. Such payments are usually held to be a permanent addition to surplus and not available for dividends, though it is doubtful if there can be any legal objection to distributing such surplus in the form of dividends.

Bonus Stock. To promote the sale of stock, bonds, or other securities, a corporation sometimes offers a bonus in the form of capital stock. For instance, one share of common stock may be given as a bonus with each share of preferred stock sold at par. Stock given as a bonus is usually taken from treasury stock or donation stock. An account with Bonus Stock should be opened and this would be charged with the par value of the stock given as a bonus, and Treasury Stock or Donation Stock would be credited, provided such stock was originally charged to the Treasury Stock or Donation Stock accounts at par. If such treasury stock or donation stock had been set up at cost, then the Bonus Stock account would be charged at the same price, and the difference between the cost price and the par value would be charged to Discount on Capital Stock or some other similar account. The value of the stock given as a bonus is usually considered an organization expense and as such is written off over a period of years; that is, it is treated as a deferred expense.

It is not often that original capital stock is given as a bonus, for the reason that the holder thereof would be liable for the full par value of the stock. Instead of acting as an inducement to purchasers of stock, bonds, or other securities, it might have just the opposite effect. Regardless of whether bonus stock represents original capital stock, treasury stock, or donation stock, it must appear on the books as outstanding capital stock at par value.

Increase in Capital Stock. A corporation may increase the capital stock by complying with state regulations. Such stock is disposed of in the usual way, the same as stock issued at the time of the organization of the corporation. No difficulties are encountered in the accounting procedure. The stock is usually sold at par, though it may sell at a premium. Cash, or whatever is received in payment of the stock, is debited and Capital Stock credited.

To illustrate: Assume that the Goodell Manufacturing Co. decides to increase its capital stock and an authorized increase of $100,000.00 par value is provided for. The stock is subscribed and paid in cash.

(a)	Unis'd Capital Stock.....	$100,000.00	
	Auth'd Capital Stock		$100,000.00
	Increase in capital stock authorized.		
(b)	Cash....................	100,000.00	
	Unis'd Capital Stock.		100,000.00
	Stock sold at par.		

A corporation may increase its capital stock outstanding by declaring a stock dividend out of surplus instead of paying a cash dividend. This is commonly referred to as "cutting a melon."

To illustrate, assume that the Goodell Manufacturing Co. has authorized capital stock outstanding amounting to $200,000.00 and a surplus of $100,000.00. The directors meet and pass a resolution declaring a stock dividend of 25% payable out of surplus, at the same time authorizing application for an increase in the authorized capital stock of $50,000.00, the increase to be used in paying the dividend declared. The entries in journal form follow:

(a)	Surplus...................	$25,000.00	
	Dividend.............		$25,000.00
	Dividend declared.		
(b)	Unis'd Capital Stock......	25,000.00	
	Auth'd Capital Stock		25,000.00
	Increase in capital stock authorized.		
(c)	Dividend..................	25,000.00	
	Unis'd Capital Stock...		25,000.00
	Stock issued in payment of dividend, 25%.		

Decrease in Capital Stock. A reduction in capital stock may be made after being authorized by the proper state official and by complying with state statutes. The object of a decrease, in the outstanding capital stock is to eliminate a deficit occasioned by losses. Such action does not affect each stockholder's interest in the business, as there is no change in the actual assets, but it results in a book profit equal to the amount of the decrease and this book profit is an offset to the amount of the deficit. If the reduction is greater than the deficit, the excess is a credit to Surplus, though it is doubtful if such surplus should be considered available for dividends.

Assume that the Goodell Manufacturing Co. had a deficit of $25,000.00 and it had been decided to decrease the outstanding capital stock $35,000.00.

Capital Stock.................	$35,000.00	
Deficit or Profit and Loss..		$25,000.00
Surplus (permanent)......		10,000.00
Decrease in capital stock outstanding.		

2. CORPORATION LAW

Liability to Subscribers. Subscriptions to capital stock of a corporation may be made before or after incorporation. A subscription made before incorporation is an agreement to subscribe for stock. It is a contract entered into between the subscriber and incorporator or promoter and not between the subscriber and corporation, because the corporation, as such, does not exist until after Articles of Incorporation have been filed with the secretary of state or the proper official. A subscription to capital stock after incorporation is a contract between the subscriber and the corporation.

Conditional Subscriptions. A subscription may be conditional. The conditions may be expressed or implied. If the agreement is "to subscribe for stock when the books are opened," or "to pay for stock subscribed when the whole amount of stock agreed upon is subscribed for," such agreement constitutes a conditional subscription, such conditions being expressed. If the statutes require that a part payment must be made on subscribed stock at time of subscription but the subscriber fails to make payment, such failure does not always make the agreement void. The courts, in some cases, have held that the corporation may waive the condition if it desires to do so. The theory of these decisions is that the provision is for the benefit of the corporation only.

Liability for Breach of Subscription Agreement. If a subscriber who has agreed to subscribe for stock when the books are opened for subscription fails to do so, he cannot be held liable for the entire amount of his subscription but only for any damages the corporation may suffer as a result of his breach of subscription agreement.

Misrepresentation and Fraud. A subscriber is supposed to have informed himself regarding the nature of the subscription paper which he signs. He is also supposed to have investigated the charter and by-laws of the corporation and to be familiar with the statutes governing corporation organization. He cannot claim misrepresentation as a ground for avoiding his subscription contract. Of course, if he can prove that he was fraudulently induced to become a subscriber to the capital stock or a member of the corporation, he can avoid his subscription or withdraw from the corporation. He must report such fraud immediately upon discovery, for he cannot remain a member of the corporation while business is good, knowing that fraud has been committed, and then use it as a means of withdrawing when the corporation becomes financially embarrassed.

When a Subscription may be Withdrawn. A subscriber may withdraw his subscription any time before the company is organized. Death revokes a subscription unless it has become legally binding before the subscriber died. After the company has been organized, the subscriber cannot withdraw his subscription, neither is he released from his subscription by the fact that another subscriber, whose subscription induced him to subscribe, has since unlawfully withdrawn his subscription. A subscriber is released from all obligations if any alterations are made in the Articles of Incorporation or there is an attempt made to transfer the subscription to a new company without his consent.

Liability on Stock Purchased at a Discount. If a subscriber purchases stock at a discount, he may be held liable for the difference between the purchase price and par value of the stock subscribed. Even if there has been an agreement between the subscriber and corporation that the stock is not to be paid for in full, and the stock is issued as fully paid, such agreement may not prove to be valid as against the corporation's creditors. If the corporation is not able to meet its obligations, the subscriber may be forced by the creditors to pay full par value for all stock subscribed.

Liability on Subscriptions to Bank Stock. In the case of a subscription to bank stock, the liability is for double the par value. To some extent, this accounts for the fact that bank stock frequently sells, originally, for more than par value, the premium being a credit to surplus. It is not infrequent that a bank will begin business with a paid-in surplus almost or as great as the amount of capital stock issued, even though not a cent of earned surplus has resulted from operations.

Exchange of Property for Capital Stock. If stock is paid for by transferring title in property, it is generally held that as long as there is no actual fraud in determining the value of the property, whatever price it is taken at, shall be final, and the subscriber is released from further liability to the corporation or its creditors. This is true even though the property may be overvalued. In certain instances, however, it has been held that overvaluation of property transferred in payment of stock is prima facie evidence of fraud. In such cases, the discrepancy would have to be satisfactorily explained or made up by the subscriber. The term "property" may include good will, patents, franchises, copyrights, trade-marks, and other intangible assets.

3. ACCOUNTING PRACTICE

To illustrate the principles discussed herein, there follows a solution of a problem taken from a recent C. P. A. examination.

Proposition A

J. B. Brown and L. C. Smith are partners and, in order to raise more capital and to preserve the organization, they decide to incorporate. A company was duly incorporated under the name of The Eclipse Company, with an authorized capital of $800,000.00, divided into 8,000 shares of the par value of $100.00 each.

The partners agreed to sell for the sum of $800,000.00, payable in capital stock of the corporation at par, all rights to and title in the net assets of the partnership, exclusive of the cash, which was divided between the partners in proportion to their several interests at the time of the sale of the property.

According to the articles of partnership, Brown and Smith were equally interested in the assets, but the profits and losses were on a basis of 60% and 40% respectively.

The partnership Balance Sheet at the time of sale was:

Balance Sheet

ASSETS		LIABILITIES	
Land and Buildings	$200,000.00	Notes Payable	$100,000.00
Cash	10,000.00	Accounts Payable	40,000.00
Inventories	100,000.00	Net Worth:	
Accounts Receivable	150,000.00	Brown's Capital	210,000.00
Machinery and Equipment	100,000.00	Smith's Capital	210,000.00
	$560,000.00		$560,000.00

For the purpose of providing working capital, the partnership donated $300,000.00 of the capital stock to the corporation which was subsequently sold at $50.00 per share.

You are required to:

1. Close the partnership books, showing ledger accounts of partners only.
2. Open corporation books.
3. Prepare a Balance Sheet of the corporation before sale of donated stock.
4. Prepare a Balance Sheet after sale of donated stock.

Solution

The only doubtful point in the problem is the basis for the valuation of the stock to be divided between Brown and Smith. The problem does not indicate that the good will of the firm was valued at $90,000.00, though this is undoubtedly the case. One might solve the problem on the basis of any one of three different assumptions. (1) The capital stock acquired by the partners might be considered as having been taken over at par. (2) It might be considered as worth what was paid for it, that is, $82.00 per share. (5,000 shares @ $82.00=$410,000.00,

which is equivalent to the net assets as shown by the Balance Sheet of the partnership.) (3) It might be considered as worth 50 cents on the dollar. (The net worth of the partners, excluding cash, is $400,000.00, for which the partners received capital stock with a par value of $800,000.00.)

The following solution is based on the assumption that there was an agreement between the partners and the corporation that they were to donate $300,000.00 of the capital stock back to the issuing company for the purpose of providing working capital. This $300,000.00 represents an overvaluation of good will. The partners actually sell to the corporation a business with a net worth of $410,000.00 for $500,000.00 of capital stock; hence it is assumed that the difference between the net worth and the purchase price represents the value of good will acquired by the corporation.

1. The following entries are designed to close the partners' books of account:

Notes Payable	$100,000.00	
Accounts Payable	40,000.00	
Capital Stock (Eclipse Co.)	500,000.00	
Land and Building		$200,000.00
Inventories		100,000.00
Accounts Receivable		150,000.00
Mach. and Equip.		100,000.00
Profit and Loss		90,000.00
Sold the entire business to The Eclipse Co. for capital stock with a par value of $800,000.00 with an agreement to the effect that there was to be donated back to The Eclipse Co. capital stock of a par value of $300,000.00, the transfer of donated stock being completed at the time of sale.		

It will be seen that there remains on hand $10,000.00 in cash and capital stock with a par value of $500,000.00. Since the valuation of the good will resulted in a realization of a profit of $90,000.00, this profit must, of course, be divided in accordance with the profit and loss sharing ratio, which is on the basis of 60% to J. B. Brown and 40% to L. C. Smith; hence, Brown would be entitled to $54,000.00 and Smith, $36,000.00.

Profit and Loss	$90,000.00	
J. B. Brown		$54,000.00
L. C. Smith		36,000.00
To distribute profits to partners in accordance with their profit and loss sharing basis: Brown, 60%, Smith, 40%.		

This increases Brown's capital to $264,000.00 and Smith's capital to $246,000.00.

The problem further states that the net assets are to be divided between the partners in proportion to their several interests at the time of sale of the property. At first, it would seem that Brown and Smith, whose capital is given as $210,000.00 each, should share in the net assets equally. However, the Balance Sheet of the partnership as given did not take into consideration the value of good will subsequently found to be $90,000.00. This good will representing a profit must, of course, be divided in accordance with the profit sharing ratio. After such division of the profits, the partners' proportionate capital is thereby affected. Their proportionate holdings are now found to be 44/85 (Brown) and 41/85 (Smith).

The following entry shows the proper distribution of the net assets between the partners:

J. B. Brown	$263,999.97	
L. C. Smith	246,000.03	
Cash		$ 10,000.00
Cap. Stock (Eclipse Co.)		500,000.00
To distribute the net assets to partners in proportion to their several interests at the time of sale: Brown, 44/85, Smith, 41/85.		

The ledger accounts of the partners now appear as follows:

J. B. Brown

Cash	$ 5,176.47	Original Capital	$210,000.00
Cap. Stock (Eclipse Co.)	258,823.53	Profit, 60%	54,000.00
	$264,000.00		$264,000.00

L. C. Smith

Cash	$ 4,823.53	Original Capital	$210,000.00
Cap. Stock (Eclipse Co.)	241,176.47	Profit, 40%	36,000.00
	$246,000.00		$246,000.00

2. The following entries are designed to open the corporation books:

Unissued Capital Stock	$800,000.00	
Capital Stock Authorized		$800,000.00
The Eclipse Co. was duly incorporated this date with an authorized capital stock of $800,000.00, divided into 8,000 shares of the par value of $100.00 each.		

Land and Buildings.........	$200,000.00	
Inventories.................	100,000.00	
Accounts Receivable.........	150,000.00	
Machinery and Equipment...	100,000.00	
Good Will..................	390,000.00	
Notes Payable..........		$100,000.00
Accounts Payable.......		40,000.00
Unissued Capital Stock..		800,000.00

To record the purchase of the business conducted by J. B. Brown and L. C. Smith, partners, acquiring title to all assets and good will, excepting cash, and assuming all liabilities.

By agreement, Brown and Smith donate $300,000.00, par value, of the capital stock back to the issuing company for the purpose of providing working capital.

Donation Stock.............	$300,000.00	
Donated Working Capital		$300,000.00

To record the donation of capital stock by Brown and Smith.

The donation stock was subsequently sold at $50.00 per share, hence a working capital of $150,000.00 was acquired. Since the donation stock did not command a price equivalent to its par value, it is certain that the Good Will account has been inflated, and the discount on the donation stock should be credited to the Good Will account.

Cash......................	$150,000.00	
Donated Working Capital....	150,000.00	
Donation Stock.........		$300,000.00

Sold donation stock, par value, $300,000.00, at $50.00 per share.

Donated Working Capital....	$150,000.00	
Good Will..............		$150,000.00

To close Donated Working Capital account into Good Will.

If donated working capital were credited to Surplus instead of to Good Will, the concern would, in fact, be overcapitalized, and the Good Will account would be inflated.

THE ECLIPSE COMPANY
Balance Sheet
(3. BEFORE SALE OF DONATION STOCK)

ASSETS

CURRENT ASSETS:			
Accounts Receivable		$150,000.00	
Inventories		100,000.00	$250,000.00
FIXED ASSETS:			
Land and Buildings		$200,000.00	
Machinery and Equipment		100,000.00	300,000.00
Total Assets			$550,000.00

LIABILITIES

CURRENT LIABILITIES:			
Notes Payable		$100,000.00	
Accounts Payable		40,000.00	$140,000.00
NET WORTH:			
Capital Stock	$800,000.00		
Less Donation St'k	300,000.00	$500,000.00	
Donated Working Capital		300,000.00	
		$800,000.00	
Less Book Value of Good Will		390,000.00	410,000.00
Total Liabilities and Net Worth			$550,000.00

(4. AFTER SALE OF DONATION STOCK)

ASSETS

CURRENT ASSETS:		
Cash	$150,000.00	
Accounts Receivable	150,000.00	
Inventories	100,000.00	$400,000.00
FIXED ASSETS:		
Land and Buildings	$200,000.00	
Machinery and Equipment	100,000.00	300,000.00
Total Assets		$700,000.00

LIABILITIES

CURRENT LIABILITIES:		
Notes Payable	$100,000.00	
Accounts Payable	40,000.00	$140,000.00
NET WORTH:		
Capital Stock	$800,000.00	
Less Book Value of Good Will	240,000.00	560,000.00
Total Liabilities and Net Worth		$700,000.00

A. THEORY QUESTIONS

1. How is treasury stock created on the books of a company? C. P. A. Ex.

2. Mention and explain two common views concerning the treatment of donated capital stock. Inst. Ex.

3. A company with an authorized capital of $500,000.00, par value $100.00, issues 4,000 shares in payment of various properties. In order to secure working capital, the stockholders return to the company three-eighths of their holdings to be sold at 50 and on the same day 500 shares are sold and paid for.

How would you treat the matter? Draft entries and show ledger accounts and balances. C. P. A. Ex.

4. What would be your procedure in regard to the Balance Sheet of a corporation, where shares of stock received from a purchaser to whom they have been issued as fully paid, and who had returned them in settlement of a claim for fraudulent misrepresentation in respect of the property sold by him to the corporation? C. P. A. Ex.

5. In making a Balance Sheet audit, you find an account with Treasury Stock debited $20,000.00. This represents a purchase of 250 shares of the company's common stock, par value $100.00. How would you treat this item on the Balance Sheet? C. P. A. Ex.

B. LEGAL QUESTIONS

1. What is meant by issuing of stock, and in return for what may stock lawfully be issued? C. P. A. Ex.

2. What is usually necessary before a subscriber to capital stock can be sued for the amount of his subscription? C. P. A. Ex.

3. Is the agreement between shareholders and the corporation that all shares shall be deemed fully paid up effectual as against creditors? Explain. Inst. Ex.

4. Subscribers to the capital stock of a corporation pay in only 70% of their subscriptions. Its business proves unprofitable and it suspends with insufficient property to pay its debts. Have creditors any remedy on account of the unpaid portion of the subscription for stock? C. P. A. Ex.

5. In a certain stock corporation only 50% of the subscribed capital has been called. David Scheld has paid all the installments called, and has loaned to the company an additional sum, for which he has taken its promissory note, and has transferred the note to William Deen, who demands payment. May the company call further installments on David Scheld's stock, and offset the amount so called against the promissory note held by William Deen? C. P. A. Ex.

C. ACCOUNTING PROBLEMS

1. (a) A and B, partners, organize a corporation with a capital stock of $500,000.00 to take over their business. The corporation issues its entire capital stock to A and B in payment of their plant and equipment, which is valued at $300,000.00. The entry recording this transaction is as follows:

Plant..........................	$500,000.00	
Capital Stock...........		$500,000.00

For the purpose of furnishing working capital, A and B each donate to the corporation $100,000.00 of their stock. What entry would you suggest to show the exact state of affairs at this point?

(b) Assuming the plant to be valued at $500,000.00, give the proper entry to record the stock donation. Give reasons for your entries. C. P. A. Ex.

2. A corporation is organized under the laws of the State of Michigan, with capital stock $250,000.00, of which $100,000.00 is preferred and $150,000.00 is common stock, shares $100.00 each. The purchasers of preferred stock at par are to receive an equal amount of common stock free, all the preferred stock is subscribed and paid for, leaving $50,000.00 of common stock unsubscribed.

It is found that the remaining common stock cannot be sold for sufficient cash for requirements, and the holders of preferred stock donate to the treasury $50,000.00 of their common stock. The common stock is sold at 50 cents on the dollar.

Provide journal entries covering the above. C. P. A. Ex.

3. A corporation is organized with a capital of $1,000,000.00 in 100,000 shares at $10.00 each, 50,000 shares of which are common stock and 50,000 shares preferred stock. 20,000 shares of the preferred stock have been sold at par, on which an assessment of $5.00 per share has been paid.

Subsequently it was determined by the stockholders to donate one share of the common stock of the company to the purchaser of each share of the preferred stock, the original subscribers to the 20,000 shares on which an installment of $5.00 per share was paid to receive the benefit of such offer upon the payment of the balance of their subscription. The effect of this offer was that all the preferred stock was sold and the balance of the installment due was also paid.

Give journal entries for all the above, placing the transactions at intervals of one month. C. P. A. Ex.

Chapter Six

CORPORATION ACCOUNTING

1. ACCOUNTING THEORY

Dividend Defined. "A dividend is that portion of the profits and surplus funds of the corporation which has been actually set apart by a resolution of the board of directors, or by the shareholders at a corporate meeting, for distribution among the shareholders according to their respective interests, in such a sense as to become segregated from the property of the corporation, and to become the property of the stockholders distributively." —Cyclopedia of Law and Procedure.

From this definition we may deduce the following facts:

(a) A dividend is a distribution of profits.

(b) A dividend is declared by resolution of the board of directors.

(c) A dividend must be distributed among the stockholders pro rata according to their respective holdings.

(d) After dividends have been declared, they become the property of the stockholders, and constitute a trust fund in the hands of the directors for the benefit of the stockholders and cannot be disposed of in any manner other than as intended except by permission and with the formal consent of the stockholders.

(e) After declaration of dividends, the stockholders in reality become creditors of the corporation. (If a stockholder is indebted to the corporation the dividend may be applied as an offset to the debt.)

Kinds of Dividends. While dividends are usually distributed in cash, it is not infrequent that dividends are distributed in property, capital stock, or scrip. If a corporation has accumulated a large surplus, and the funds have been invested in fixed assets or stock-in-trade, it might be found advisable to distribute the dividend in treasury stock, unissued capital stock, property or in scrip so as to retain the funds in the business until some future date. If the firm had invested a large amount of funds in liberty bonds during the war, it might distribute these liberty bonds as a dividend.

Cash Dividend. The most common dividend is known as a cash dividend. In fact, unless otherwise designated, the term "dividend" refers to a distribution of cash. Sometimes a company will declare a dividend out of profits and may be

forced to borrow the money with which to pay the dividend. It must be understood that profits are not always represented in the cash balance, and that while the Balance Sheet of a corporation may show a very large surplus there may be a very small cash balance.

Stock Dividend. A stock dividend may be declared out of surplus when funds are not available for distribution of a cash dividend. Treasury stock or unissued capital stock may be used for the purpose of distributing a stock dividend. If all the authorized capital stock is outstanding, it may be necessary for the corporation to provide for an increase in the capital stock by securing permission from the proper state official, usually the Secretary of State. A distribution of stock as a dividend always causes an increase in the amount of outstanding capital stock, and may represent an increase in the authorized capital stock.

Scrip Dividend. In some cases, corporations may wish to retain the funds in the business temporarily and may, therefore, distribute dividends in the form of scrip, which is simply a certificate of indebtedness, or a promissory note. These certificates are usually interest-bearing. The benefit to the company in issuing a scrip dividend is that it can retain the funds for working capital for the time being, but, of course, the funds must finally be used in liquidating the scrip that has been issued.

Property Dividend. A distribution of any kind of property other than cash may be termed a "property dividend." Many dividends have recently been paid in liberty bonds, and in 1916, a large munitions manufacturer declared a dividend payable in Anglo-French bonds.

Ex-Dividend. This is a term used in connection with a dividend paid to the holder of record of stock sold between the date of the declaration of the dividend and the date of payment.

Liquidating Dividend. A distribution of assets at the time of dissolution of a corporation is known as a "liquidating dividend." Such a dividend has no relation to profits or surplus, but relates entirely to a realization of assets and a distribution of the proceeds.

Declaration of Dividend. A dividend is declared by formal resolution of the board of directors at a corporate meeting. After a dividend has been declared, the secretary may either notify the stockholders of the declaration, indicating the

rate, the amount, date of payment and any other details of importance, or a formal notice of declaration may be published in the newspapers.

Payment of Dividend. A dividend may be declared to be paid at some future date. In small corporations, payment is usually made by currency or by check, the stockholders signing a receipt. The practice in large corporations is to deposit the required amount in the bank in a specific fund for dividends and draw checks against this fund. If a dividend is paid in currency, the stockholder is usually required to acknowledge receipt of same by his signature in a dividend book. Naturally this policy can be carried out in only very small or close corporations.

2. CORPORATION LAW

Dividends. Dividends may be declared only from the net profit or surplus. It is illegal in all states to declare dividends out of capital, except in case of dissolution. The advisability of declaring dividends is left to the board of directors. Should the directors declare a dividend and such dividend act as an impairment of capital, they may be held individually and criminally liable for having done so.

Dividends Must Be Declared Out of Profits. There is no doubt but that it is the intention of the law in all the states to protect the general creditors of the corporation by forbidding directors to declare dividends that might impair the capital of the corporation. Any dividend declared in excess of the current and accumulated profits would constitute a certain impairment of the capital. This might easily prove a matter of serious consequence to the creditors. The United States Supreme Court has defined profits as "surplus over and above the capital and debts of the corporation." Dividends need not necessarily be paid out of current profits, but may represent a distribution of the accumulated profits, and in some cases the courts have held that dividends may be paid out of profits resulting from an increase or appreciation of assets.

The New York Supreme Court in a decision in 1914 stated that "A corporation has a very wide discretion in determining when a dividend shall be made. There might be a difference of opinion in a given case as to the wisdom of accumulating a large surplus which otherwise would be applicable to the payment of dividends, but that would not be a subject for legal interference where the discretion is fairly exercised. If the defendant corporation has the right to accumulate a surplus, it has the right to invest the surplus in securities, and if the

securities appreciate in value, there is no reason why the profits arising from the investment should not be regarded as the profits of the business of the corporation."

Distributing Capital in the Form of Dividends.* "There is a popular notion, especially among stockholders of companies owning and operating mineral, timber, oil, and quarry lands, buildings on leased ground, etc., that such companies are exempt from the general rule that the original capital must be kept intact, and are consequently permitted to exhaust their capital by distributing to stockholders the balance of their surplus accounts without making provision for depletion or amortization of mineral deposits, stumpage, etc. There appears to be no legal sanction for this belief, but, as the provision of law to the effect that capital may not be impaired by the payment of dividends is solely for the protection of creditors and stockholders, in the absence of any protest by them to distributions consisting partly of income and partly of return of capital, the courts have no occasion to interfere.

"The theoretical result of distributing to stockholders the profits without providing for depletion, etc., is that upon exhaustion of the property (or termination of the lease, when the property reverts to the lessor), and after all liabilities are paid, and the net profits shown by the Surplus account distributed to stockholders, only two accounts remain on the books, Property and Capital Stock—there being no property, the capital stock is valueless. However, examples of such a procedure are now rare, as most corporations whose products are obtained from natural deposits or growth charge their cost of production with the cost (actual or estimated) of the material removed, crediting their property accounts. The principle is well illustrated by a comparison of two coal mining companies—one leasing and the other owning its property. The former pays a royalty of a certain amount per ton mined, which is charged to cost. The latter has paid for its coal in advance by buying the property; therefore, cost should be charged at a rate per ton representing the total cost of the property divided by the estimated total tonnage—the Property account being credited. Under such a method, the total net profit shown by the books may be distributed, and after the property is exhausted and all liabilities paid, the Capital Stock account will be offset by cash or some investment thereof other than property. Manifestly, if adequate provision for depletion be made by charges to surplus, any distributions to stockholders not in excess of the credits to surplus are dividends out of income. They can constitute repayments on account of capital only to the extent that they exceed the credits to surplus.

*From a thesis on Corporation Organization and Accounting, by William H. Bell. Accepted by the St. Louis University in partial fulfillment of the requirements for the degree of Master of Commercial Science.

"Some mining corporations in making provision for depletion of mineral deposits credit the amounts to reserves instead of to the property accounts. Then they make distributions to the stockholder, in addition to regular dividends, said to be out of the depletion reserves and, therefore, constituting repayments on account of capital. If the distributions were actually charged to the depletion reserves, the provisional charges to surplus would be nullified, as the net book value of the property would not be reduced; but the distributions would constitute repayments on account of capital only if the entire net income credited to surplus had been paid out as dividends. Regardless of the bookkeeping entries, if the company makes provision for depletion, the rule stated above holds; namely, that any distributions to stockholders, under whatever designation, constitute repayments of capital only to the extent that they cause a deficit to be shown in the accounts."

Who May Declare Dividends. Except in case of specific limitation imposed by the statutes, the Articles of Incorporation, or the by-laws of the corporation, the directors have entire control over the declaration of dividends. However, there are circumstances under which the stockholders may institute proceedings in a court of equity to compel a distribution of dividends.

Cases are numerous in which the minority stockholders have brought successful legal action against the directors compelling them to declare dividends. In these cases, the stockholders proved that the directors were not acting in good faith, but were concealing the true profits by paying themselves large salaries as officers and that they were withholding profits not actually needed in the business. When it can be shown that the board of directors is guilty of fraud or misappropriation of the corporate funds, and refuses to declare dividends when the corporation has a surplus which can be divided among the stockholders without detriment to the business, it may be forced by the stockholders to make a distribution of profits.

Surplus Available for Dividends. In the case of noncumulative preferred stock, it will readily be seen that should the directors not declare a dividend, the stockholders may lose their right to dividends; hence, the courts will be more likely to take action. There is one outstanding fact in the distribution of dividends, and that is the board of directors cannot declare dividends except out of profits. Even when profits justify a dividend, the matter is left largely to the discretion of the board of directors. While there seems to be no doubt but that dividends may be declared out of surplus resulting from appreciation of assets, donations by stockholders, or from surplus resulting from the sale of stocks and bonds at a premium, it is doubtful if such a distribution of the surplus would represent a wise policy.

Dividends on Stock Not Fully Paid. Subscribers to be entitled to dividends must have paid for their stock in full, and such stock must be recorded in their names. Only stockholders of record are entitled to dividends. If it happens that all subscribers have made only partial payments on stock subscriptions and if they are all on the same basis, a dividend may be distributed. The question then arises as to whether the dividend should be credited to the stock accounts of the subscribers or should be paid in cash. Either plan may be adopted. The better plan would seem to be to credit the accounts of the subscribers with the amount of the dividend, thus reducing the amount due on account of their subscriptions.

Dividends Payable Only to Stockholders of Record. Since dividends are payable only to holders of record, it will be seen that a stockholder to be entitled to his share of the dividend must see that his holdings are properly recorded on the books of the company. Usually the directors, when declaring a dividend, specify that it is to be paid to all stockholders of record on a certain date. When purchasing outstanding capital stock, it is important that it be immediately transferred on the books of the issuing company. Original issues of capital stock should, of course, be properly recorded without any action on the part of the subscriber.

Dividends on Preferred and Common Stock. Dividends on preferred stock must be paid before the common stockholders share in the dividend. If the dividend on preferred stock is cumulative, then all dividends in arrears must be paid before common stockholders are to share in the dividends. After the preferred stockholders are satisfied, all the common stockholders share alike in the dividends. While the dividends on preferred stock may be limited to a certain per cent., usually six or seven per cent., no such limitation exists as to common stock. All dividends must be equal as between holders of the same class of stock, whether preferred or common. Holders of either class of stock cannot be favored either as to time of payment or as to the amount of payment. The usual plan is for the company to mail all dividend checks at the same time.

Treasury Stock Does Not Draw Dividends. To pay dividends on stock held in the treasury would constitute a payment by the company to itself. Sometimes the stock is held by a trustee, in which case dividends may be paid thereon, and the trustee will be charged for the amount paid.

Stock Dividends. Dividends may be paid in stock instead of in cash when the company has the right to increase the capital stock. This may be done when all the stock authorized has never been issued or when the company secures permission to increase the amount of its capital stock.

3. ACCOUNTING FOR DIVIDENDS

No difficulties are encountered in the accounting for dividends. Sound accounting requires that upon declaration of a dividend, it should be charged to Profit and Loss or Surplus and credited to the Dividend account. When payment is made, such payments should be charged to the Dividend account. The Dividend account will balance when the total dividend has been distributed. In a small or close corporation the dividend might be distributed in cash as soon as declared. In such cases, the dividend might be immediately charged to Profit and Loss or Surplus, though it is doubtful if this would be considered the best procedure. It would seem more sound in all cases to set up a Dividend account, numbering each consecutive dividend.

How Dividends are Paid. In a small corporation the dividend might be paid in cash or by check and the stockholders may acknowledge receipt of same by signing the dividend list or record. In this case the payments will be entered in the cash book and posted to the debit side of the Dividend account, writing the name of each stockholder in the explanation column. It will, however, be seen that in a large corporation this procedure would not be practical.

To avoid the necessity of making a large number of entries in the cash book for dividend payments and posting such entries to the Dividend account, one check may be drawn for the amount of the dividend. This check will be deposited in the bank as a special dividend fund. Another check book may be used to draw individual checks against this fund. At the time the dividend check is deposited, an entry should be made crediting Cash and debiting a special Dividend Drawing account. As the dividend checks are presented for payment at the bank, and when the bank has submitted a statement thereof, the amount paid is credited to the Dividend Drawing account and debited to the Dividend account. When this plan is carried out, the balance of the Dividend account represents checks outstanding. The balance of the Dividend account is, however, offset by the balance of the Dividend Drawing account.

Entries Incident to Distribution of a Cash Dividend. This is the most common form of distributing a dividend; in fact, it is the usual method pursued. The accounting procedure is indeed simple and seldom are any difficulties encountered.

Proposition A

To illustrate the proper procedure, let us assume that the Johnson Manufacturing Co. has an outstanding capital stock of $100,000.00 and a surplus of $25,000.00. The board of directors, at its annual meeting on December 31, 1920, declares a dividend of 10 per cent. payable in cash to stockholders of record on February 1, 1921.

Solution

At the time of the declaration of the dividend the following entry should be made in the corporation journal:

December 31, 1920

Surplus	$10,000.00	
Dividend No. 1		$10,000.00
A dividend of 10% payable to stockholders of record on February 1, 1921, has this date been declared by the board of directors, as per minutes of meeting.		

The bookkeeper might next prepare a dividend list showing the number of the dividend, date declared, date payable, name and address of each stockholder, number of shares owned, amount of dividend to be paid, date of payment and number of dividend check. If it is desired to add a column providing for the signatures of the stockholders upon receipt of dividend it may be done, and the plan may be carried out without difficulty in the case of a small corporation.

Assuming that the corporation on February 1, 1921, drew a check for $10,000.00 and deposited in the bank as a special dividend fund, the following entry may be made in the cash book:

February 1, 1921

Deposit for Dividend No. 1	$10,000.00	
Cash		$10,000.00
Deposited $10,000.00 in First National Bank as a special fund for dividend purposes.		

Individual checks may now be written in favor of each stockholder of record for the amount of the dividend to which he is entitled. These checks should be mailed on the same date to all the stockholders. It would be best to use a special check book for this purpose, because these checks are drawn against the special fund deposited for dividend purposes, and the writing of these checks in no way affects the company's regular bank account. Nothing more than a memorandum entry need be made on the books. Let us further assume that on February 28 the bank renders a statement showing that all dividend checks have been presented for payment. The only entry necessary at this time is what might be termed an "adjusting" entry in the corporation journal.

February 28, 1921

Dividend No. 1	$10,000.00	
Deposit for Div. No. 1		$10,000.00

All dividend checks issued February 1, 1921, have been honored by the bank per bank statement of this date.

If all dividend checks had not been paid by the bank, the adjusting entry should be made the same as above with the exception that the amount charged to the Dividend account and credited to the Deposit account would represent the exact total of dividend checks honored by the bank. The balance of the Dividend account is the same as the balance of the Deposit account, and is equal to the total of dividend checks outstanding which have not as yet been presented to the bank for payment.

Entries Incident to Distribution of a Property Dividend. We have already shown in this discussion that the board of directors may declare a dividend in property, such as liberty bonds.

Proposition B

To illustrate the proper procedure, let us assume that the Johnson Manufacturing Company owned liberty bonds with a par value of $15,000.00 and the board of directors had decided in their meeting on December 31, 1920, that a dividend of 10 per cent. should be paid by distributing liberty bonds on February 1, 1921.

Solution

There is only a slight change in the accounting for a property dividend as compared with a cash dividend. There appears below the necessary entries in journal form with suitable explanation but without further comment:

December 31, 1920

Surplus	$10,000.00	
Dividend No. 1		$10,000.00

A dividend of 10%, payable in liberty bonds to stockholders of record on February 1, 1921, has this date been declared by the board of directors as per minutes of meeting.

February 1, 1921

Dividend No. 1	$10,000.00	
Liberty Bonds		$10,000.00

A 10% dividend has this day been distributed to stockholders in liberty bonds.

Entries Incident to Distribution of a Scrip Dividend. Scrip is a certificate of indebtedness constituting a promissory note, and the object of its issue is to retain the funds temporarily in the hands of the company for working capital. Such certificates may be interest-bearing, and there are instances where long-term scrip certificates have been issued on which stockholders were entitled to dividends, though this is not common.

Proposition C

To illustrate the proper procedure, let us assume that the Johnson Manufacturing Co. declared the regular annual dividend of 10 per cent. on December 31, 1920, payable in 6 per cent. scrip to stockholders of record on February 1, 1921, the scrip certificates to be payable six months after date of issue.

Solution

There follows a series of journal entries incident to the declaration and payment of a scrip dividend per the above proposition.

December 31, 1920

Surplus	$10,000.00	
Dividend No. 1		$10,000.00

A dividend of 10%, payable to stockholders of record on February 1, 1921, has this day been declared by the board of directors as per minutes of meeting. The scrip certificates are payable in cash with interest at 6% six months after date of issue.

February 1, 1921

Dividend No. 1	$10,000.00	
Dividend Scrip		$10,000.00

Scrip payable, amounting to $10,000.00, has this day been distributed to stockholders as a dividend.

August 1, 1921

Dividend Scrip	$10,000.00	
Interest	300.00	
Cash		$10,300.00

Scrip payable, $10,000.00, with interest at 6%, $300.00, has this day been paid in cash.

Entries Incident to Distribution of Stock Dividends. If a dividend is paid in stock, the accounting procedure will not differ materially. If treasury stock is distributed, the credit will be to Treasury Stock account instead of to a cash or property account. If unissued capital stock is distributed, the credit will be to Unissued Capital Stock account. If no stock is held in the treasury and all authorized capital stock has been issued, the board of directors may secure permission to increase the capital stock and then distribute the unissued capital stock in the form of a dividend. In distributing a stock dividend the company really parts with nothing at all. Such a distribution of dividend involves no withdrawal of cash or other assets. In fact, it is nothing more than a manipulation of the accounts. The value of a stockholder's interest in a corporation is not affected one cent by the distribution of a stock dividend. It must be remembered that the value of a share of capital stock is not dependent upon the amount written on the certificate. The actual value of a share of stock may be quite different from its par value. If a corporation, capitalized at $100,000.00 has built up a surplus of $100,000.00, it will readily be seen that the actual value of one share of stock will be $200.00 while the par value is still $100.00. If a stock dividend of 100 per cent. is distributed, the holder of one share of stock will be given another share, and, instead of owning one share of stock worth $200.00, he will then own two shares of stock worth $100.00 each.

Proposition D

To illustrate the proper procedure, let us assume that the Johnson Manufacturing Co. held $10,000.00 of its own capital stock in the treasury, such stock having been acquired by purchase. The board of directors, December 31, 1920, decided to distribute a dividend of 10 per cent., payable in treasury stock on February 1, 1921, all other conditions being the same as in Proposition A.

Solution

The following entries in journal form indicate the accounting procedure in connection with the above proposition:

December 31, 1920

Surplus	$10,000.00	
Dividend No. 1		$10,000.00

A dividend of 10%, payable in treasury stock to stockholders of record on February 1, 1921, has this day been declared by the board of directors as per minutes of meeting.

February 1, 1921

Dividend No. 1	$10,000.00	
Treasury Stock		$10,000.00

Treasury stock, with a par value of $10,000.00, has this day been distributed to the stockholders as a dividend.

If the corporation had not issued all its authorized capital stock, it might have decided to distribute a stock dividend out of the unissued capital stock instead of treasury stock. The only difference in the accounting procedure in this case would be in the credit going to Unissued Capital Stock instead of to Treasury Stock.

Dividend No. 1	$10,000.00	
Unissued Capital Stock		$10,000.00

Unissued capital stock, with a par value of $10,000.00, has this day been distributed to the stockholders as a dividend.

As to the benefits to be derived from a distribution of a stock dividend, we can do no better than to quote a paragraph from the "Principles of Accounting" by Paton and Stevenson.

"The issue of a stock dividend, evidently, obscures the amount of accumulated surplus and the amount of original investment. This statement suggests a common reason for such dividends. Corporations which are making huge profits, and which wish to pay but an ordinary rate of dividends on formal capitalization will often gradually transfer their accumulated earnings from the Surplus to the Capital Stock account. It is then possible to declare much larger aggregate cash dividends at the same normal rate on formal capital. In connection with public utilities, this practice may also be made the basis of an argument for the maintenance of rates. A corporation, it is urged, should be allowed a fair rate on its outstanding securities. Evidently, such an accounting practice gives the corporation an opportunity to beg the real question as to what rate per cent. is being earned, or should be allowed, on actual investment."

A. THEORY QUESTIONS

1. What is a dividend? State when and how dividends become effective. State how declaration and payment of dividends are usually recorded in books of account. C. P. A. Ex.

2. What do you understand by the term "dividends paid out of capital"? What, in your opinion, would constitute such payment, and mention any circumstances that may occur to you to justify such payment. C. P. A. Ex.

3. How would the excessive distribution of dividends affect the individual stockholders of a corporation? C. P. A. Ex.

4. In a case where the preferred shares of a company are issued under a provision that the annual dividends to which they shall be entitled shall be "cumulative," would you consider it necessary to show any arrears of dividends as a liability on the Balance Sheet, or how would you deal with it? C. P. A. Ex.

5. An Indiana company is incorporated with a capital stock of $100,000.00, of which $90,000.00 was paid in.

In making their application for the charter, all the stock was subscribed. The full capital, however, was not required.

It was recently decided that, inasmuch as a surplus of $15,000.00 had accumulated, they would declare a stock dividend, pro rata, for the $10,000.00 of stock unissued but subscribed for by one of the present stockholders.

No action on the transaction was taken by the board of directors, and no record of it appears in the minutes of the corporation.

Is it necessary that a transaction of this character be recorded in the minutes, inasmuch as all of the stock was originally subscribed?

What would be your recommendations in regard to the proper procedure in this matter? C. P. A. Ex.

B. LEGAL QUESTIONS

1. From what funds may dividends be paid, and who determines whether and when they shall be paid? Inst. Ex.

2. What are the rights of the holders of preferred stock as to dividends? Inst. Ex.

3. Some days before a cash dividend is declared A sells his shares to B, without stipulating as to the ownership of the dividends. Do they belong to A, who owned the stock when the dividend was earned, or to B, who owned it when the dividend was declared? C. P. A. Ex.

4. (a) Discuss net profits out of which dividends may lawfully be declared and when, if at all, the capital may be distributed in dividends.

(b) What right, if any, has a corporation to set off against the stockholders' share of the dividends a debt owed by him to the corporation at the time the dividend is declared?

(c) Before a dividend has been declared, what right or action has a shareholder, both in law and equity, in case the dividend has been earned? C. P. A. Ex.

5. A sells some railroad stock to B, who fails to have the certificate, which has been signed in blank on the back, replaced by a new one. A dividend is declared to stockholders of record, and the check is sent to A.

Who is legally entitled to the dividend? Explain.

C. P. A. Ex.

C. ACCOUNTING PROBLEMS

1. At a meeting of the board of directors of a corporation held August 15, 1920, the treasurer reported that the profits for the year as audited amounted to $118,574.00. It was voted that a stock dividend of $80,000.00 be paid October 1, 1920, out of treasury stock, to the stockholders of record September 15, 1920, and that $20,000.00 of the profits be distributed as a bonus to employes.

Prepare the necessary entries to properly record the action of the directors as it appears in the minutes of the meeting. Also show entries for payment of bonus to employes and distribution of dividend to stockholders on October 1, 1920.

C. P. A. Ex.

2. The books of the Butter, Egg & Cheese Company, with an authorized and outstanding capital stock issue of $25,000.00, are kept by single entry.

It annually inventories all of its assets and liabilities and from such inventory prepares a financial statement. At December 31, 1913, this inventory is as follows:

Office Cash	$ 1,584.00
Balance Bank, A	10,824.00
Accounts Receivable	29,521.00
10 Shares Stock in Competing Company	1,000.00
Plant and Equipment	64,938.00
Merchandise Inventory	21,737.00
Prepaid Expenses	5,081.00
Overdraft Bank, B	5,003.00
Accounts Payable	19,747.00
Mortgage Payable	25,000.00
Notes Payable	20,000.00

From a comparison of the financial statements at the beginning and end of year, you find that the item of Plant and Equipment is stated in an amount less by $11,460.00 than it was at the beginning of the year, plus additions during the year.

The financial statement for the beginning of year showed a surplus of $35,703.00.

From your analysis of the disbursements and unpaid Accounts Payable at beginning and end of year, you find a total of purchases amounting to $661,910.00 and expenses for salaries, wages, supplies, repairs, etc., amounting to $120,115.00.

The purchases, however, included $450.00 paid out for John Smith, an employe, for which he had not reimbursed the company, and the total expenses of $120,115.00 included $250.00 in the hands of a buyer as a working fund.

The inventory of merchandise at the beginning of the year was $18,125.00 and of prepaid expense was $2,653.00.

There was canceled on the customers' ledger during the year $3,206.00 of uncollectible accounts.

There was paid for interest and discount on Notes Payable $1,061.00 and for interest on mortgage $1,500.00.

A 10% dividend was declared but not paid.

From the foregoing prepare—

(a) A Balance Sheet as at December 31, 1913.

(b) A Profit and Loss statement exhibiting Net Sales, Cost of Sales and Gross and Net Profit for the year.

C. P. A. Ex.

3. Below is the Balance Sheet of the X. L. O. Mfg. Co., January 1, 1920:

ASSETS

Cash	$ 31,718.40	
Accounts Receivable	118,455.00	
Inventory:		
Raw Material	50,560.80	
Finished Goods	18,958.20	
Office Furniture and Fixtures	4,500.00	
Land	108,000.00	
Machinery	150,000.00	
Buildings	90,000.00	
Total Assets		$572,192.40

LIABILITIES

Accounts Payable	$21,289.20	
Dividends Payable, Preferred Stock, February 1, 1920	4,500.00	
Dividends Payable, Common Stock, February 1, 1920	6,000.00	
Twenty-Year Mortgage Bonds, 6%, dated January 1, 1919	60,000.00	
Premium on Bonds	3,000.00	
Capital Stock, Preferred	150,000.00	
Capital Stock, Common	300,000.00	
Reserve for Bad Debts	2,830.80	
Surplus	24,572.40	
Total Liabilities and Net Worth		$572,192.40

The transactions for the year ending December 31, 1920, were as follows:

Cash Received from Customers	$476,100.60
Rents Received	360.00
Raw Materials Purchased	147,840.00
Sales	494,000.40
Discount and Allowances on Sales	14,111.40
Bad Debts Charged Off	1,285.80

Cash Disbursements:

Accounts Payable	$146,013.60
Factory Expenses	4,493.40
Factory Labor	210,855.60
Factory Repairs	14,305.80
Office Expense	1,156.20
Selling Expense	31,748.40
Salaries	35,082.60
Taxes	4,711.80

Inventories December 31, 1920:

Raw Material	$ 54,462.54
Finished Goods	18,505.20
Land Estimated at	120,000.00

Semiannual dividends of 3% on preferred and 2% on common stock, declared in June and December, payable August 1 and February 1. Reserve for depreciation of buildings, 3%; machinery, 5%; office furniture and fixtures, 10%, and bad debts reserve, 2% of accounts receivable.

Prepare: Operating statement and Balance Sheet as on January 1, 1921.

Assume that the semiannual bond interest of $1,800.00 was paid when due.

C. P. A. Ex.

Chapter Seven

CORPORATION ACCOUNTING

1. ACCOUNTING THEORY

Combinations. The public accountant in these times is frequently called upon to draft organization entries, prepare annual statements, make audits, and prepare tax returns for holding companies and corporations representing combinations of two or more companies. Such combinations are the result of mergers and consolidations for the purpose of controlling the operations of affiliated or subsidiary companies.

Merger. A merger is brought about through amalgamation of constituent companies. No new corporation is formed. One company simply acquires title to the property of another company.

Kester says: "The rights, franchises and interest are deemed to be transferred to and vested in the corporation into which the various companies have been merged without any deed or transfer, and the liabilities follow the rights."

Accounting in Connection with Mergers. Ordinarily no difficult accounting problems are encountered in connection with the formation of mergers. Cox, in "Business Accounting," says: "The purchase transaction if simple and usual in character, may be recorded in one journal entry, which, reduced to the most simple terms, consists of a list of assets of the subsidiary concern offset by its liabilities, capital stock, and profit or surplus." In other words, if one corporation purchases the entire property of another corporation, the accounts may be consolidated on the books of the purchasing company by drafting a journal entry, debiting the assets acquired, crediting the liabilities assumed, and crediting Cash for the difference which represents the purchase price. Of course, it is true, that many peculiar accounting questions may be encountered in the valuation of the property items and in the statement of the liabilities. The above discussion, however, is applicable after the books of the merged company have been audited and a Balance Sheet prepared to show true values.

Kester says: "The bookkeeper is not concerned with the valuation of any of the items taken over, but must make his entries in accordance with the valuation report turned in by the appraisal committee. The main problem in the merger, then, is of valuation and not of accounting."

Holding Companies. The formation of a holding company may be brought about through the organization of a new company for the purpose of acquiring the controlling interest in certain subsidiary companies and controlling their operations. In states where the law permits, one company may simply purchase all or a majority of the capital stock of other companies,

with the idea of controlling their operations. In the former instance, the holding company is usually a financial organization. Its income is derived entirely from dividends of its subsidiary companies. In the latter, the holding company is both a financial and an operating organization. It can readily be seen that the Balance Sheet of a holding company, which is nothing more than a financial organization, would show nothing more than its investments in subsidiary companies as assets and capital stock and surplus as liabilities, plus accounts resulting from intercompany transactions.

Advantages of Consolidation. The advantages of consolidation may be summed up briefly as follows:

1. Reduction of Expenses. By reducing the number of salesmen in common territory made possible by elimination of competition, by eliminating duplicate executive officers, and by consolidating certain departments, selling and administrative, expenses may be reduced.

2. Specialization. By specialization along certain lines in each factory, duplication in manufacturing and equipment may be eliminated. Each factory may confine itself to a product which it is best fitted to produce most economically, either because of location, equipment, or labor conditions.

3. Release of Working Capital. After consolidation, the surplus stock of finished goods, stock patterns and sizes, may be much smaller than the stock previously carried by all the companies when operated independently; hence a smaller amount of working capital is tied up in surplus stock to meet future demands, resulting in additional working capital for other operations.

4. Better Qualified Men. The consolidated company with its larger organization, greater production, and broader opportunities, naturally attracts men of higher qualifications and greater ability for executive positions. The company is able to employ better qualified men since the cost may be distributed over all the constituent companies and need not necessarily be borne entirely by a single company.

5. Ease in Securing Capital. The consolidated company possesses better facilities for borrowing money and obtaining additional capital when needed. The holding company may be able to finance certain subsidiary companies as a result of its ability to borrow money, whereas the subsidiary company operating independently might be seriously handicapped because of its inability to borrow money.

6. Larger Profits. More substantial profits and less danger of unexpected losses result from a partial monopoly and an opportunity to regulate the selling price without being influenced by the supply in demand, or by competition. How-

ever, should the holding company operate unfairly and eliminate competition to the extent of "restraining" trade, it may come into conflict with such laws as the Sherman Anti-Trust Law and the Clayton Act.

7. Elimination of Competition. This was touched upon in the preceding paragraph. The effect of consolidation is to eliminate competition between the consolidated companies. The affiliated companies, by agreement, may regulate prices, divide territories, distribute material and products, etc. It will be seen that if all the companies producing a certain product were to amalgamate, they would be in a position to entirely control prices of their products. Competition would be eliminated. Such an affiliation of concerns is commonly known as a monopoly or trust.

Consolidated Statements. As has already been stated, when a merger is completed, the accounts are usually consolidated by means of a journal entry on the books of the purchasing company. This is a simple procedure. The books of the merged companies are closed and the companies dissolved. With the formation of a holding company, there is no change in the financial accounts of the subsidiary companies. They are not dissolved, but continue to operate and to keep accounts entirely independent of the holding company's accounts. Therefore, in preparing statements that will show true conditions and results of the operations of all the companies comprising the consolidation, it is necessary to prepare consolidated statements. A Balance Sheet of the holding company would not show the financial condition of the subsidiary companies upon which the holding company is dependent.

Dickinson, in "Accounting, Practice and Procedure," says: "By reason of the misleading character of the ordinary Balance Sheet in such cases, there has been evolved the Consolidated Balance Sheet; the basis of which is the recognition of the common-sense fact that a network of companies connected with each other by control of stockholdings is still, in effect, one undertaking, and that if the stockholders in the holding company are to have before them a clear statement of its position, legal technicalities must be brushed to one side, and the position of the holding company shown in its relation, not to these sub-companies, but to the general public. The position of the holding company can be changed only by outside influences affecting itself or its constituent companies, and not by any change in the relation between itself and these companies, or in the relation among the latter. The Consolidated Balance Sheet represents the true position of the whole group of the constituent companies to the outside world, and is thus not the Balance Sheet of a corporation, but of a condition after eliminating all the relations of the constituent companies one to another."

2. INCOME TAX PROCEDURE

Consolidated Returns. Corporations which are affiliated are required to submit consolidated returns of their income and invested capital. The taxes are computed and determined on the basis of the consolidated return.

Income Tax Law. (Section 240-A.) That corporations which are affiliated within the meaning of this section shall, under regulations to be prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income and invested capital, * * * and the taxes thereunder shall be computed and determined upon the basis of such return.

How Tax is Assessed. The tax is assessed upon the basis of the consolidated return, and is computed as an account and then assessed upon the respective affiliated corporations in such proportions as they may agree upon. Or, in the absence of an agreement among the affiliated corporations, it is assessed on the basis of the net income properly assignable to each of the affiliated corporations.

Income Tax Law. (Section 240-A.) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit of $2,000.00 (as provided in Section 236); in computing the war-profits credit (as provided in Section 311) only one specific exemption of $3,000.00; and in computing the excess-profits credit (as provided in Section 312) only one specific exemption of $3,000.00.

When Corporations are Affiliated. (Reg. 45.) Corporations will be deemed to be affiliated (a) when one domestic corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (b) when substantially all the stock of two or more domestic corporations is owned or controlled by the same interests. The words "substantially all the stock" cannot be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or controlling of 95 per cent. or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required even though the stock ownership is less than 95 per cent. When the stock ownership is less than 95 per cent., but in excess of 50 per cent., a full

disclosure of affiliations should be made, showing all pertinent facts, including the stock owned in each subsidiary or affiliated corporation and the percentage of such stock owned to the total stock outstanding. Such statement should preferably be made in advance of filing the return, with a request for instructions as to whether a consolidated return should be made. In any event such a statement should be filed as a part of the return. The words "the same interests" shall be deemed to mean the same individual or partnership or the same individuals or partnerships, but when the stock of two or more corporations is owned by two or more individuals or by two or more partnerships, a consolidated return is not required unless the percentage of stock held by each individual or each partnership is substantially the same in each of the affiliated corporations.

Income Tax Law. (Section 240-B.) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

Affiliated Corporations. (Reg. 45.) The provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation. Where one corporation owns the capital stock of another corporation or other corporations, or where the stock of two or more corporations is owned by the same interests, a situation results which is closely analogous to that of a business maintaining one or more branch establishments. In the latter case, because of the direct ownership of the property, the invested capital and net income of the branch form a part of the invested capital and net income of the entire organization. Where such branches or units of a business are owned and controlled through the medium of separate corporations, it is nessessary to require a consolidated return in order that the invested capital and net income of the entire group may be accurately determined. Otherwise opportunity would be afforded for the evasion of taxation by the shifting of income through price fixing, charges for services and other means by which income could be arbitrarily assigned to one or another unit of the group. In other cases without a consolidated return, excessive taxation might be imposed as a result of purely artificial conditions existing between corporations within a controlled group.

Filing Consolidated Returns. (Reg. 45.) Affiliated corporations are required to file consolidated returns on Form 1120. The consolidated return shall be filed by the parent or principal reporting corporation in the office of the collector of the district

in which it has its principal office. Each of the other affiliated corporations shall file in the office of the collector of its district Form 1122, along with the several schedules indicated thereon. The parent or principal corporation filing a consolidated return shall include in such return a statement specifically setting forth (a) the name and address of each of the subsidiary or affiliated corporations included in such return, (b) the par value of the total outstanding capital stock of such corporations at the beginning of the taxable year, (c) the par value of such capital stock held by the parent corporation or by the same interests at the beginning of the taxable year, (d) in the case of affiliated corporations owned by the same interests, a list of the individuals or partnerships constituting such interests, with the percentage of the total outstanding stock of each affiliated corporation held by each of such individuals or partnerships during all of the taxable year, and (e) a schedule showing the proportionate amount of the total tax which it is agreed among them is to be assessed upon each affiliated corporation. Foreign corporations and personal service corporations need not file consolidated returns.

Personal Service Corporation. (Reg. 45.) A corporation cannot be considered a personal service corporation when another corporation owns or controls substantially all of its stock, or when substantially all of its stock and of the stock of another corporation (not itself a personal service corporation) forming part of the same business enterprise is owned or controlled by the same interests.

Consolidated Net Income of Affiliated Corporations. (Reg. 45.) Subject to the provisions covering the determination of taxable net income of separate corporations, and subject further to the elimination of intercompany transactions, the consolidated taxable net income shall be the combined net income of the several corporations consolidated, except that the net income of corporations coming within the provisions of Article 635 shall be taken out. In respect of the statement of gross income and deductions and the several schedules required under Form 1120, a corporation filing a consolidated return is required to prepare and file such statements and schedules in columnar form to the end that the details of the items of gross income and deductions for each corporation included in the consolidation may be readily audited.

Domestic Corporation Affiliated with Foreign Corporation. (Reg. 45.) A domestic corporation which owns a majority of the stock of a foreign corporation shall not be permitted or required to include the net income or invested capital of such foreign corporation in a consolidated return, but for the purpose of Section 238 of the statute, a domestic corporation which owns a majority of the voting stock of a foreign corporation shall be entitled to credit its income, war-profits and excess-profits

taxes with any income, war-profits or excess-profits taxes paid (but not including taxes accrued) by such foreign corporation during the taxable year to any foreign country or to any possession of the United States upon income derived from sources without the United States in an amount equal to the proportion which the amount of any dividends (not deductible under Section 234) received by such domestic corporation from such foreign corporation during the taxable year bears to the total taxable income of such foreign corporation upon or with respect to which such taxes were paid. But in no such case shall the amount of the credit for such taxes exceed the amount of such dividends (not deductible under Section 234) received by such domestic corporation during the taxable year.

3. ACCOUNTING PRACTICE

Proposition A

The following problem is stated for the purpose of illustrating the preparation of consolidated statements. A solution with detailed discussion of principles involved follows the statement of the problem.

A, a holding company, which is also an operating company, owns 95% of the stock of B, and 100% of the stock of C. The stock of B appears on the books of A at $80,000.00. The stock of C appears on the books of A at $175,000.00. The surplus of B at date of acquisition was $5,000.00, and the surplus of C at date of acquisition was $25,000.00. Dividends during the year following acquisition were paid as follows: B, $10,000.00; A, $100,000.00.

Balance Sheets of A, the holding company, and of B and C, subsidiary companies, appear as follows:

A (HOLDING COMPANY)

Balance Sheet

Assets		Liabilities	
Cash	$150,000.00	Accounts Payable	$ 50,000.00
Accounts Receivable	175,000.00	Notes Payable	100,000.00
Inventories	220,000.00	Bonds	500,000.00
Investments:		Net Worth:	
B, Capital Stock (par value $95,000.00)	80,000.00	Capital Stock	1,000,000.00
C, Capital Stock (par value $100,000.00)	175,000.00	Surplus	425,000.00
Intercompany Accounts	100,000.00		
Deferred Charges	25,000.00		
Good Will	250,000.00		
Properties $1,000,000.00 Less Depr. 100,000.00	900,000.00		
	$2,075,000.00		$2,075,000.00

B

Balance Sheet

Assets		Liabilities	
Cash	$ 10,000.00	Accounts Payable	$ 75,000.00
Accounts Receivable	50,000.00	Intercompany Accounts	85,000.00
Inventories	100,000.00	Notes Payable	30,000.00
Good Will	50,000.00	Net Worth:	
Properties . . $100,000.00		Capital Stock	100,000.00
Less Depr. . 10,000.00	90,000.00	Surplus	10,000.00
	$300,000.00		$300,000.00

C

Balance Sheet

Assets		Liabilities	
Cash	$ 20,000.00	Accounts Payable	$ 70,000.00
Inventories	75,000.00	Intercompany Accounts	5,000.00
Properties . . $200,000.00		Net Worth:	
Less Depr. 20,000.00	180,000.00	Capital Stock	100,000.00
		Surplus	100,000.00
	$275,000.00		$275,000.00

Draft journal entries to make necessary adjustments and eliminate intercompany transactions. Prepare Consolidated Balance Sheet.

Solution

Stock Acquired at a Discount. It will be noted that the surplus of B at time of acquisition by A, the holding company, amounted to $5,000.00. The par value of B's capital stock was $100,000.00. A purchased 95% of the capital stock, or $95,000.00, and in addition 95% of the surplus, or $4,750.00. This investment appears on the books of A at $80,000.00, consequently it is evident that the stock was acquired at a discount. It is generally held that a premium paid above par value represents good will, but in case the price paid falls below the sum of the surplus and par value of the capital stock purchased, it is an indication that the assets on the subsidiary companies' books are overvalued. In either case, an adjustment must be made through the Property or Good Will accounts. In this problem, the adjustment can be made for the discount on stock purchased from B by means of a credit to Good Will for the difference between the amount paid and the book value on the books of A.

(1)	B, Capital Stock	$95,000.00	
	Surplus	4,750.00	
	Investment in B, Capital Stock		$80,000.00
	Good Will		19,750.00

Minority Stockholders' Holdings. After making the above adjustment, it will be seen that $5,000.00 of the capital stock remains in the hands of the minority stockholders. In other words, it is left in the hands of the general public. It is desired to show separately the outstanding capital stock of the holding company from the stock of the subsidiary companies not owned by the holding company, hence the following adjusting entry:

(2)	B, Capital Stock...............	$5,000.00	
	Minority stockholders' holdings in B, Cap. Stock.....		$5,000.00
	Par value of B, Capital Stock, not held by controlling company, but remaining in the hands of the public.		

Surplus. It will still be noted that of the surplus on the books of B at date of acquisition, there remains $250.00 that has not been adjusted. This is the proportion of the surplus at that date applicable to the stock held by minority stockholders, and this should be transferred from surplus to the account with Minority Stockholders.

(3)	Surplus......................	$250.00	
	Minority stockholders' interest in Surplus of B.....		$250.00
	Proportion of surplus of B at date of acquisition applicable to stock in the hands of minority stockholders.		

The actual surplus on the books of B at date of above Balance Sheet is $10,000.00, hence it is evident that $5,000.00 of this surplus has accrued since date of acquisition. 5% of this is applicable to the stock owned by minority stockholders and this must be transferred to their account.

(4)	Surplus......................	$250.00	
	Minority stockholders' interest in Surplus of B.....		$250.00
	Proportion of surplus of B since date of acquisition applicable to stock in the hands of minority stockholders.		

Stock Acquired at a Premium. In acquiring the capital stock of C, it will be noted that the holding company purchased all the capital stock, amounting to $100,000.00. At date of acquisition, the surplus of C amounted to $25,000.00, hence the book value of the capital stock acquired by A amounts to $125,000.00. This is carried on the books of A at $175,000.00. The holding company paid a premium of $50,000.00 on the stock acquired. It is, therefore, evident that A has paid $50,000.00 for good will.

(5)	C, Capital Stock	$100,000.00	
	C, Surplus	25,000.00	
	Good Will	50,000.00	
	Investment in C, Capital Stock		$175,000.00
	To charge to Good Will the difference between the par value and surplus of C, Capital Stock, at date of acquisition by A and the actual sum paid.		

Intercompany Accounts. In examining the intercompany accounts on the Balance Sheets of the three companies, it will be noted that on the Balance Sheet of A, the intercompany account appears as an asset amounting to $100,000.00. On the Balance Sheet of B, the intercompany account appears as a liability amounting to $85,000.00, and on the Balance Sheet of C, it appears as a liability amounting to $5,000.00. Combining the intercompany accounts from the Balance Sheets of B and C, it will be seen that the combined liability is $90,000.00, $10,000.00 less than the amount appearing on the Balance Sheet of A, hence it is evident that the intercompany accounts are not in agreement.

Let us assume that an investigation shows that the difference arises because of a shipment of goods, made by one company and valued at $5,000.00, had not been received or taken up by the receiving company, and that a remittance of $5,000.00 made by one company had not been received by the other company.

(6)	Inventories	$5,000.00	
	Intercompany Accounts		$5,000.00
	Shipment by A to B not taken up by B.		
(7)	Cash	$5,000.00	
	Intercompany Accounts		$5,000.00
	Cash in transit. Remittance by C to B not yet received by B.		

Profits on Intercompany Sales. While it is true that transfers of products and sales of service between the affiliated companies should be at cost, yet it sometimes occurs that intercompany sales include a profit, in which case an examination of the books must be made to determine whether any of this intercompany profit is included in the inventory of stock on hand.

In this problem, we shall assume that one of the companies sells to another and that there is an intercompany profit in inventories of $10,000.00 requiring adjustment. Such intercompany profit should be adjusted as follows:

(8) Surplus	$10,000.00	
Inventory		$10,000.00
Intercompany profit in inventories at end of year.		

The above shows the proper adjustment for intercompany profits in inventories at end of year resulting from the fact that goods are not transferred between the affiliated companies at cost. If a profit will result in inventory at end of the year, it is natural that profits will result similarly in inventories at the beginning of the year. To illustrate this principle, let us assume that the intercompany profits at the beginning of the year amounted to $7,500.00.

(9) Surplus at beginning of year—A.	$7,500.00	
Profit and Loss		$7,500.00
For intercompany profits in inventory at beginning of year.		

Where inventories are reduced to net integration cost before being taken up on the books of the various affiliated companies, the last two adjusting entries are not required.

Surplus Working Sheet. In making the eliminating and adjusting entries for the Surplus Working Sheet, the debits and credits to Surplus on the Working Sheet for Consolidated Balance Sheet have to be applied to the various items in the analysis of the surplus. In this problem, all the entries can be readily applied to the proper items with the exception of the debit of $250.00 for the proportion applicable to the stock in the hands of minority stockholders of the surplus of B accumulated since acquisition of the controlling interest by A.

Surplus from date of acquisition* to beginning of year, 5% of $2,500.00	$125.00
Proportion of profits for year, 5% of $12,500.00	625.00
	$750.00
Less—Proportion of dividend, 5% of $10,000.00	500.00
	$250.00

The Working Sheet for the Consolidated Balance Sheet and Surplus Account are illustrated on following pages. It will be noted that the above adjusting entries have been transferred and that the accounts are properly consolidated so that it is a simple matter to set up a Consolidated Balance Sheet from the information given in the last column. Working Sheets are not called for in the problem and are not necessarily a part of the required solution, but are illustrated here in order to simplify the solution and that the principles may be more easily comprehended.

* The date of acquisition is not shown in the problem. The proportion of surplus accrued previous to beginning of year is arbitrarily arrived at.

WORKING SHEET FOR CONSOLIDATED BALANCE SHEET

Accounts	A	B	C	Adjustments Additions	Adjustments Deductions	Consolidated Accounts
Assets:						
Properties	$1,000,000.00	$100,000.00	$200,000.00			$1,300,000.00
Less Depreciation	100,000.00	10,000.00	20,000.00			130,000.00
	900,000.00	90,000.00	180,000.00			1,170,000.00
Good Will	250,000.00	50,000.00		(5)50,000.00	(1) 19,750.00	330,250.00
Investments:						
B, Cap. Stock (par val. $95,000.00)	80,000.00				(1) 80,000.00	
C, Cap. Stock (par val. $100,000.00)	175,000.00				(5)175,000.00	
Inventories	220,000.00	100,000.00	75,000.00	(6) 5,000.00	(8) 10,000.00	390,000.00
Accounts Receivable	175,000.00	50,000.00				225,000.00
Cash	150,000.00	10,000.00	20,000.00	(7) 5,000.00		185,000.00
Deferred Charges	25,000.00					25,000.00
Intercompany Accounts	100,000.00	*85,000.00	*5,000.00		(6) 5,000.00 (7) 5,000.00	
	$2,075,000.00	$215,000.00	$270,000.00	$60,000.00	$294,750.00	$2,325,250.00
Liabilities:						
Capital Stock	$1,000,000.00	$100,000.00	$100,000.00		(1)$95,000.00 (2) 5,000.00 (5)100,000.00	$1,000,000.00
Minority Stockholders' holdings in subsidiary companies (at book value)				(2) 5,000.00 (3) 250.00 (4) 250.00		5,500.00
Bonds	500,000.00					500,000.00
Notes Payable	100,000.00	30,000.00				130,000.00
Accounts Payable	50,000.00	75,000.00	70,000.00			195,000.00
Surplus	425,000.00	10,000.00	100,000.00		(1) 4,750.00 (3) 250.00 (4) 250.00 (5) 25,000.00 (8) 10,000.00	494,750.00
	$2,075,000.00	$215,000.00	$270,000.00	$5,500.00	$240,250.00	$2,325,250.00

*Figures in Italics are deductions.

WORKING SHEET FOR SURPLUS ACCOUNT

Accounts	A	B	C	Adjustments		Consolidated Accounts
				Additions	Deductions	
Surplus of subsidiary companies prior to acquisition by holding company		$5,000.00	$25,000.00		(1)$4,750.00 (3) 250.00 (5)25,000.00 (9) 7,500.00	
Surplus at beginning of year—A	$300,000.00					
Surplus of subsidiary companies from date of acquisition to beginning of year		2,500.00	100,000.00		(4) 125.00	$394,875.00
Profit for year, excluding dividends from subsidiary companies	65,500.00	12,500.00	75,000.00	(9)7,500.00	(8)10,000.00 (4) 625.00	149,875.00
Intercompany dividends	109,500.00	**10,000.00*	**100,000.00*	(4) 500.00		
Dividends paid by holding company	**50,000.00*					**50,000.00*
Surplus at end of year	$425,000.00	$10,000.00	$100,000.00	$8,000.00	$48,250.00	$494,750.00

* Figures in Italics are deductions.

A, B AND C CONSOLIDATED BALANCE SHEET

Assets			Liabilities	
Cash		$ 185,000.00	Accounts Payable	$ 195,000.00
Accounts Receivable		225,000.00	Notes Payable	130,000.00
Inventories		390,000.00	Bonds	500,000.00
Good Will		330,250.00	Minority Stockholders' holdings in subsidiary Cos.	5,500.00
Deferred Charges		25,000.00	Net Worth:	
Properties	$1,300,000.00		Capital Stock	1,000,000.00
Less Depreciation	130,000.00	1,170,000.00	Surplus	494,750,00
Total Assets		$2,325,250.00	Total Liabilities and Net Worth	$2,325,250.00

A. THEORY QUESTIONS

1. In examining several manufacturing properties with a view of consolidation, what general rules should govern the examinations? C. P. A. Ex.

2. Four corporations, which have been doing business with each other, consolidate. In each set of books, accounts are open with the other three. How will these be treated in the Consolidated Balance Sheet? C. P. A. Ex.

3. If in consolidating the accounts of a holding company and its subsidiary companies, you find that in the case of one of the subsidiary companies the holding company owns only 60% of its voting stock, state briefly how you would treat this subsidiary company's accounts in the Consolidated Balance Sheet and why your proposed treatment reflects the true financial position of the combined companies more clearly than other methods with which you may be familiar. Inst. Ex.

4. In making up a Consolidated Balance Sheet of a holding or parent company, and two subsidiary companies where, in the case of one of the subsidiary companies, its entire capital stock has been acquired at less than par, and in the case of the other, at a substantial premium, how would you deal with such discount and premium, respectively, in the Consolidated Balance Sheet? C. P. A. Ex.

5. In the event that all the stock of the subsidiary companies was not owned by the parent company, how should such proportion of said stock belonging to the minority stockholders, together with the proportion of surplus appertaining thereto, be stated in the Balance Sheet? C. P. A. Ex.

INCOME TAX QUESTION

Name two conditions under which corporations should file consolidated returns and the requirements of evidence of affiliation. C. P. A. Ex.

B. ACCOUNTING PROBLEMS

1. The A Company buys on January 1, 95% of the stock of the B Company. The Balance Sheet of the latter company on that date is as follows:

BALANCE SHEET—B COMPANY

Assets		Liabilities	
Current Assets...$	850,000.00	Cur. Liabilities..$	250,000.00
Property Accts...	500,000.00	Capital.........	1,000,000.00
		Surplus.........	100,000.00
	$1,350,000.00		$1,350,000.00

The A Company pays par for 90% of the stock, and 120 for 5% of it. During the next six months, a doubtful claim of the B Company, which prior to January 1 had been written off, turns out to be good, and $5,000.00 cash is realized on it.

At the end of the first six months, B Company has made $100,000.00 net profit from operations, and a dividend of $200,000.00 is paid.

In making up a Consolidated Balance Sheet of A Company and its subsidiaries at January 1 (date of purchase) state, giving briefly your reasons, how you would treat:

(a) A Company's interest in the B Company and at July 1.
(b) The doubtful claim recovered.
(c) The dividend paid.
(d) The interest of outside B stockholders in B Company.

Inst. Ex.

2. The following items appear on the Balance Sheet of the American Pin Company, June 30, 1912: land, buildings, equipment, etc., $335,000.00; capital stock of the Bronx Pin Ticket Company, par $50,000.00; cost, $57,400.00; patents, $15,000.00; working and trading assets, $37,500.00; cash $10,000.00; accounts receivable, $32,000.00; due from Bronx Pin Ticket Company, $375.82; deferred assets, $1,500.00; first mortgage 6% gold bonds payable, due 1922, $100,000.00; taxes accrued, $3,250.00; salaries and wages accrued, $4,327.82; accounts payable, $123,749.83; notes payable and interest, $80,125.00; interest accrued on first mortgage bonds payable, $2,500.00; reserve for depreciation of building and equipment, $35,000.00; preferred capital stock outstanding, $75,000.00; common capital stock outstanding, $50,000.00; profit and loss surplus, $14,823.17.

The American Pin Company having acquired all the capital stock of the Bronx Pin Ticket Company, the Balance Sheet of which appears below, it is proposed to merge the two companies as of July 1, 1912.

THE BRONX PIN TICKET COMPANY

ASSETS—Land, buildings and equipment, etc., $260,000.00; capital stock of the Blauser Pin Tray Company carried at par, $35,000.00; patents, $22,625.00; working and trading assets, $10,000.00; cash, $10,365.27; accounts receivable, $37,943.86; sinking fund, $3,236.92; deferred charges to expense, $1,200.00. LIABILITIES AND CAPITAL—First mortgage 5% gold bonds payable, due 1925, $50,000.00; taxes accrued, $2,750.00; salaries and wages accrued, $3,147.83; due to creditors, $144,720.30; due to American Pin Company, $375.82; notes payable and interest, $31,372.53; interest accrued on first mortgage bonds payable, $1,250.00; reserve for depreciation of plant and equipment, $27,500.00; common capital stock outstanding, $50,000.00; profit and loss surplus, $69,254.57.

Prepare:

(a) The entries on the books of the American Pin Company.

(b) The entries on the books of the Bronx Pin Ticket Company.

(c) Balance Sheet of the American Pin Company after the merger.

3. On January 1, 1916, Company X purchased the entire capital stock of Company Y at $175.00 per share, and all the stock of Company Z at $80.00 per share.

A Balance Sheet, as stated below is handed to you, as at June 30, 1916, with the request to prepare a Consolidated Balance Sheet of the X Company and its subsidiary companies at that date.

BALANCE SHEET—COMPANY X

Property and Good Will	$510,000.00	Capital Stock	$1,350,000.00
Stock of Subsidiary Companies	900,000.00	Current Liabilities	90,000.00
Current Assets	420,000.00	Surplus, 1/1/16	315,000.00
		Undivided profits for half year ended 6/30/16	75,000.00
	$1,830,000.00		$1,830,000.00

BALANCE SHEET—COMPANY Y

Property and Good Will	$390,000.00	Capital Stock	$240,000.00
Current Assets	36,000.00	Current Liabilities	6,000.00
		Surplus, 1/1/16	120,000.00
		Undivided profit for half year ended 6/30/16	60,000.00
	$426,000.00		$426,000.00

BALANCE SHEET—COMPANY Z

Property, 1/1/16	$678,000.00	Capital Stock	$600,000.00
Current Assets	108,000.00	Current Liabilities	144,000.00
		Surplus, 1/1/16	18,000.00
		Undivided profit for half year ended 6/30/16	24,000.00
	$786,000.00		$786,000.00

There are no intercompany accounts or inventories.

C. P. A. Ex.

Chapter Eight

SYSTEMATIZATION

Accounting Systems. Public accountants devise systems for various classes of concerns including mercantile, manufacturing, financial, public service, municipal, ecclesiastical, etc. Systems are quite commonly described as general accounting systems and cost accounting systems. Strictly speaking, any accounting system is a cost system, for is it not one of the principal objects of any accounting system to show costs—prime cost, cost of production, cost of sales, cost of operations, etc.?

The Federal Trade Commission on July 15, 1916, addressed a letter to retail merchants saying in part: "The Federal Trade Commission has found that the majority of retail merchants do not know accurately the cost of conducting their business, and for this reason they are unable to price their goods intelligently. There must be decided improvement in this direction before competition can be placed upon a sound basis and before we can expect a decrease in the heavy business death rate among retail merchants."

About the same time, the Commission in a letter to American manufacturers, said in part: "The Federal Trade Commission has found that an amazing number of manufacturers, particularly the smaller ones, have no adequate system for determining their costs and price their goods arbitrarily."

While it is possibly true that cost accounting is a special branch of accounting, yet it must be remembered that it is only a branch of general accounting and that experience has proven that cost accounting systems which are not a part of the general accounting systems are a failure.

Preliminary Information. The accountant called upon to devise a system of accounts will need certain information before he can proceed in a satisfactory manner. He will want to know how the company is organized, whether a single proprietorship, partnership or a corporation; the nature of the business engaged in; the volume of the annual business; the reports and statements desired by the management; wherein the present system is inadequate or faulty; the number of bookkeepers employed; the cost of maintaining the present system; the mechanical appliances in use in the bookkeeping department, and such other information as will prove helpful in devising a system to fit a particular concern. Conditions differ in nearly every concern, and the accounting system must be adapted to existing conditions.

The accountant called in to devise a system of accounts to replace a system that has not been producing desired results is very much in the same position as the physician called to pre-

scribe a remedy for a sick man. He should feel the pulse, look at the tongue, take the blood pressure, ascertain the temperature and make a thorough examination of the system preliminary to the devising of a new system.

Fundamental Principles. In devising a system of accounts for any concern, either mercantile, manufacturing, or otherwise, there are certain fundamental principles to be observed by the accountant. The principal objects which should receive careful consideration may be stated as follows:

1. To Properly Design Books of Account. The books of account are, of course, divided into two classes—those of original entry and those of final entry. The books of original entry should be devised with suitable arrangement of columns in which to record and distribute the various items in such a manner as to afford such data for the preparation of a Balance Sheet and Statement of Profit and Loss in standard form. The accountant must see through from the books of original entry to the final statements resulting therefrom, and the items appearing on the books of original entry must directly contribute to the aggregate items appearing on the financial statements.

In planning the books of final entry, the accountant will be governed by the volume of business and the size of the force required to record the transactions. In a very small business, it is possible that a single ledger with the accounts divided into three groups—general, creditors, and customers, might prove sufficient. If, however, the volume of business is such that several bookkeepers will be required to do the posting, it will be seen that separate ledgers should be provided. Instead of dividing a single ledger into three sections, it would be better to provide a general ledger to contain the general and controlling accounts; a creditors' ledger for accounts with Trade Creditors, and a customers' ledger for accounts with Trade Customers. Again, it may be necessary to subdivide the subsidiary ledgers with creditors and customers into several sections. This is especially true with regard to customers. It may be necessary to subdivide the customers' ledger into several sections to enable several bookkeepers to work on them. The division may be made on an alphabetical, geographical, or some other basis.

2. To Properly Classify the Accounts. It is important that the accounts be properly classified. To do this it is necessary:

(a) To ascertain the character of the assets and liabilities; to determine their order of classification and to what extent they may to advantage be contained in separate accounts to the end of arriving at a permanent form in which the Balance Sheet may be clearly stated.

(b) To ascertain the sources of income and expense incidental to operations of the business, taking into consideration

the elements of cost, fixed charges, administrative expenses, maintenance or up-keep, depreciation, reserves, etc., to the end of arriving at a comprehensive and intelligible Profit and Loss statement.

Separate accounts should be provided for the assets, liabilities, expenses, and sources of income. Merchandise accounts, expense accounts, and similar accounts should be properly subdivided. A general account with merchandise or expense is nothing more than a "dumping account," and certainly has no place in a modern accounting system. In determining a proper classification of accounts, the old saying that there should be "A place for everything, and everything in its place" is quite appropriate.

3. To Promote Efficiency in Procedure and Office Routine. It is the duty of the accountant to institute suitable procedure and organization in the methods of treating with details and in recording of the transactions on the books of account with a view to economy of time, accuracy of work, and facility of balancing the accounts, and the preparation of financial statements.

4. To Provide for Internal Check and Audit. The system should be so planned as to secure the best internal check, thereby readily making apparent any irregularity which may arise from ignorance, stupidity or dishonesty on the part of employes in the accounting department.

The general principle to be followed is that no one person shall be in complete control of any important part of the business, but that the work of each employe shall be subject to check or supervision by other employes by being made to fit in with the work of others.

Controlling accounts must be kept on the general ledger with each subsidiary ledger with customers, in case there is more than one. Cash receipts should be recorded by more than one person so that fraud or embezzlement could not take place without collusion between two or more employes. Vouchers for payments should be accompanied by invoices from creditors, properly certified pay rolls, etc. Sales tickets should be made in duplicate so that the ticket which goes to the customer shall be an exact copy of the one filled in the shipping room.

The system should be susceptible of a thorough and rapid periodical audit by public accountants. Provision for an internal check is particularly desirable in mercantile accounting systems because the volume of detail in connection with the recording of purchases and sales, both cash and credit, is so great as not to lend itself readily to an audit. In a Balance Sheet audit, the auditor could do no more than test the accuracy of the sales and receipts therefrom. A detail audit would be quite out of the question because of the expense attached thereto.

Mercantile Accounting. The devising of accounting systems for mercantile concerns offers an interesting field of work for the public accountant. It is true that mercantile accounting will be found less technical than accounting for manufacturing concerns. In this discussion, we shall confine ourselves to a general accounting system for a mercantile concern. No attempt will be made to adapt the discussion to a system for a specific concern, but rather an effort will be made to discuss the general principles covering systematization.

Objects of an Accounting System for Mercantile Concerns. There are certain general objects to be obtained from a sound accounting system for mercantile concerns properly devised and properly kept. A few of the more important objects might be summed up as follows:

1. To meet current needs and provide for expansion of business in the future. The system devised should not be based solely upon the present volume of business, but should be flexible enough to allow for future expansion.

2. To enable the merchant to price his goods intelligently. There has been a tendency among retail merchants in the past to conduct their business without an adequate accounting system, hence selling prices were determined arbitrarily.

3. To furnish the management with proper and sufficient information to be used as a guide in conducting the business on sound principles; a system that will provide the necessary information from which to prepare operating and financial statements, and to compile needed statistics to be used in determining future policies.

4. To provide for a logical distribution of work, and for a proper classification of receipts and disbursements. The distribution of the work should be made in a manner that will provide a satisfactory internal check.

5. To provide complete and permanent records that can be maintained at the smallest expense. Too often, accounting systems are devised without regard to the possible cost of keeping, and it is soon found that the cost is greater than the additional benefits obtained.

6. To enable the management when seeking credit to produce a statement of financial condition upon which a banker might extend full credit to which the company is entitled. If unable to produce a proper statement for credit purposes, a possible expansion of the business might thereby be limited. Bankers are giving more and more attention to the accounting methods used by merchants to whom they extend credit.

Bankers Base Extent of Credit on Financial Condition. Bankers are willing to give larger loans and very often more liberal terms to the merchant who keeps his books in a way

that enables him to show the bank at any time just how his business is progressing. A merchant who can show progress will undoubtedly receive more consideration with the same amount of assets than one who cannot. Even if he is successful, but cannot show it because of his bookkeeping methods, the bank will not consider him a desirable credit risk.

Another very important point to which the bank gives consideration is whether the prospective borrower is making proper provisions for depreciation on stock, buildings, and fixtures, and his books should be so arranged as to show the amount of these provisions. No merchant can be said to be managing his business properly unless adequate provision is made for depreciation.

Adaptability of System to Existing Conditions. It is almost impossible to describe in detail an accounting system for a mercantile concern without assuming certain existing conditions. Any accounting system that might be devised must be adapted to the business and must provide for a certain volume of business. It will readily be seen that an accountant might be called upon to devise a system for a small mercantile concern, one in which there need be no departmentalization of the accounts, a concern in which there is required the greatest simplicity. Again, the accountant might be called upon to devise a system for a concern maintaining numerous departments and where it is desired to show the results of operations in each department. It is to be seen that the system fitting the former would not be adapted to the latter concern.

An Accounting System for a Small Mercantile Concern. The system of accounts outlined here is intended to meet the requirements of retail merchants. The object has been to describe a system that will give information essential to successful management of a small mercantile establishment. The author believes that the best accounting system for any business is the one which will furnish the required information with the least effort and cost. No attempt is made to departmentalize the accounts, though this will be taken up in a later discussion.

Books of Account. To operate the accounting system described herein requires the use of but four books of account—the journal, cash book, purchases book and ledger. Sales tickets and credit tickets will be used for recording sales and sales returns and allowances.

Journal. An ordinary two column journal can be used. This is the form of journal with which all bookkeepers are familiar. No special rulings are required, there simply being two money columns required on each page.

Cash Book. This might be termed a general cash book, for in it will be recorded all cash transactions whether representing receipts or disbursements. The left hand or debit side

is for recording receipts. Special columns should be provided in the order named:

1. Date.
2. Name of account.
3. Explanation.
4. Ledger folio (L. F.).
5. General accounts.
6. Accounts Receivable.
7. Cash Sales.

The right hand or credit side is for recording disbursements and special columns should be provided as follows:

1. Date.
2. Name of account.
3. Explanation.
4. Check No.
5. Ledger folio (L. F.).
6. General accounts.
7. Accounts Payable.
8. Discounts on Purchases.

Purchases Book. A purchases book is designed in which to record the invoices representing purchases of merchandise only. Special columns should be provided as follows:

1. Date of record.
2. Date of invoice.
3. Number.
4. From whom purchased.
5. Address.
6. Ledger folio (L. F.).
7. Terms.
8. Amount.

Sales and Credit Tickets. The use of sales and credit tickets for recording sales and sales returns and allowances has almost become universal with merchants. The sales ticket is the original record of the sales transaction. The ticket is usually made out by the sales person when making the sale; though in some cases, these tickets are made out by special clerks on a special register machine. The ticket shows the following information:

1. Number.
2. Date.
3. Name of sales person.
4. Name of customer.
5. Address of customer.
6. Description of article sold.
7. Price.
8. Terms (whether paid in full, or deposit given and balance C. O. D., or "will call").

Ledger. Either a loose-leaf or a bound ledger may be used. Loose-leaf forms add greatly to the elasticity of a system of accounting and are in most cases more economical than bound forms. The accounts should be arranged in the following order:

1. General accounts.
2. Accounts with Creditors.
3. Accounts with Customers.

If the volume of business will warrant a division of the ledger accounts, it will be best to provide a general ledger for the general accounts and subsidiary ledgers for Accounts Receivable and Accounts Payable. In this case, the general ledger will also contain the controlling accounts for the subsidiary ledgers. The general ledger must be so kept that it balances independently of the subsidiary ledgers. The subsidiary ledgers

for creditors and customers can also be made self-balancing by opening a controlling account in each. This controlling account would be just the opposite from the one in the general ledger and requires a sort of double posting. It enables the bookkeeper to take off a Trial Balance without access to the general ledger which, of course, serves as a sort of internal check on his work and avoids the necessity of his having access to the general ledger which is sometimes objectionable.

Outline of Accounts. An accountant in devising a system of accounts should prepare an outline of the accounts to be kept. The exact outline will always depend upon the nature of the business, the volume of the business and the information desired by the management. To fit the system under discussion, we shall assume a classification of accounts as follows:

Real Accounts:

1. Cash.
2. Accounts Receivable (Trade Customers).
3. Notes Receivable (Trade Customers).
4. Insurance.
5. Store Property.
6. Warehouse Property.
7. Store Equipment.
8. Office Equipment.
9. Delivery Equipment.
10. Inventory.
11. Res. for Doubtful Accounts.
12. Res. for Depr. of Store Property.
13. Res. for Depr. of Warehouse Property.
14. Res. for Depr. of Store Equipment.
15. Res. for Depr. of Office Equipment.
16. Res. for Depr. of Delivery Equipment.
17. Notes Receivable Discounted (Trade Customers).
18. Notes Payable (Trade Creditors).
19. Notes Payable (Banks).
20. Accounts Payable (Trade Creditors).
21. Accounts Payable (Others).
22. Mortgages Payable.
23. Proprietor's Drawing Account.
24. Proprietor's Capital Account.

Nominal Accounts:

51. Purchases.
52. Sales.
53. Sales Allowances.
54. Salaries and Wages of Buying Force.
55. General Buying Expense.
56. Salaries and Wages of Sales Force.
57. General Selling Expense.
58. Advertising.
59. Salaries and Wages of Delivery Force.

60. General Delivery Expense.
61. Office and Management Salaries.
62. Office Supplies and Expense.
63. Insurance.
64. Taxes.
65. Interest.
66. Miscellaneous General Expense.
67. Rent.
68. Losses from Bad Debts.
69. Cash Discount on Purchases.
70. Cash Discount on Sales.

Manufacturing the Books of Account. The accountant devises the system drawing up proper forms indicating headings to be printed, ruling desired, style of binding wanted, and then an order is given a printing company or manufacturers of blank books. Some accounting firms furnish the printer with blue prints of the forms and books desired. In any event, the printer must be furnished with information sufficient to enable him to print and manufacture the books of account. The printer will submit proofs to the accountant and these must be carefully verified with the original copy. Otherwise, the accountant will be responsible for errors should any occur in printing, ruling or binding. It probably is not out of place to state that the accountant should reach an understanding with his client as to the handling of the bills in connection with the manufacturing of the books. Usually the accountant secures permission from the client to give the order to the printing company, but the bills are to be sent direct to the client and are handled entirely separate from the bill for the accountant's services.

Accountant's Report. When the books and forms are ready for installation, the accountant usually supervises the "opening of the books." He also furnishes the head bookkeeper with a report containing detailed instructions regarding the keeping of the books of account and the proper use of the forms provided. The report should contain a description of each book of original entry, tracing the items from these books to the ledgers and from the ledgers to the statements. Each account should be described as to its use and purpose. If the accountant can prepare a report covering all the transactions, it can readily be seen that the bookkeeper will find such a report most helpful while becoming accustomed to the new system. It will also save confusion and dissatisfaction resulting from the bookkeeper's failure to understand the proper method of recording certain transactions and in preparing monthly or annual statements. Much of the success of the system will depend upon the ability of the bookkeeper to follow the instructions of the accountant.

The following report is presented to illustrate a simple report to fit the system herein described. Space permits only an explanation of the use of the books of account.

ACCOUNTANT'S REPORT

Books of Account. A journal, cash book, purchases book, and ledger are provided. The following instructions should be observed with regard to the recording of transactions in these books.

Journal. At the date the books are to be opened, a statement of assets and liabilities should be prepared. This will be used as the basis of the opening entry. Accounts representing assets should be debited and accounts representing liabilities should be credited. The proprietor should be credited for the present investment which will be the difference between the total of the assets and liabilities. The entry should be supported by a schedule of Accounts Receivable or Accounts Payable. These schedules will be used in posting to the individual accounts with customers and creditors.

The total of the account Sales for each month as shown by the sales tickets should be entered in the journal, debiting Accounts Receivable (controlling account) and crediting Sales. The total of the credit tickets for each month representing sales returns and allowances are also entered in the journal, debiting Sales with the returns and Sales Allowances with any allowances in the form of price concessions and crediting Accounts Receivable (controlling account).

Transactions which do not go through either the cash book or purchases book should also be journalized. These entries comprise such items as Notes Receivable and Payable, allowances or corrections of invoices on account of merchandise purchases previously entered in the purchases book, the various adjusting entries at the end of the month, and the closing entry at the end of the fiscal period.

Journal entries affecting accounts with customers and creditors will also have to be posted individually to the controlling account for Accounts Receivable and Accounts Payable in the general ledger.

Cash Book. The total cash receipts for each day should be deposited in the bank and all payments should be made by check. In case small cash disbursements are necessary for such as car tickets, telegrams, and minor items, it would be advisable that this be handled on the petty cash plan. A check should be drawn for an amount to cover the disbursement for a certain period, possibly one month. At the end of the period, the cashier should prepare a petty cash statement which should be

supported by vouchers and a check drawn for the exact amount of the statement, thereby restoring the petty cash fund to the original amount. This check should be entered in the cash book in the regular way charging the various expense accounts as shown by the petty cash statement.*

The total of cash sales for the month as shown by the footing of the cash sales column should be checked against the total of the cash sales tickets and then posted to the credit of Sales. The total of the Accounts Receivable column for the month is posted to the credit of Accounts Receivable (controlling account). The total of the Accounts Payable column is posted to the debit of Accounts Payable (controlling account). The total of the discount on the purchases column is also posted to the debit of Accounts Payable (controlling account). All payments for expense items other than petty cash should be entered in the cash book as made and posted therefrom to the proper accounts. At the end of the month, all expense bills for the month should be paid so as to insure the expense being charged in the proper month. (It must be remembered that this is a description of a system for a small mercantile concern and that simplicity is the principal feature of the system.)

The total cash receipts for the month should be posted to the debit of the Cash account in the general ledger. The total cash payments for the month should be posted to the credit of the Cash account in the general ledger.

The cash book balance at all times should check with the balance as shown by the check book plus the amount in the petty cash fund.

No special check book is required. At the end of the month, the cash book should be balanced, or a statement secured from the bank together with canceled checks. These should be checked with the stubs, the checks being arranged in numerical order. If any checks are outstanding, note them on the stubs and deduct from the total checks written. The check book balance should then agree with the bank book balance.

Purchases Book. The postings are made direct from this book into the purchases ledger and the total at the end of the month is posted to the debit of Purchases and to the credit of Accounts Payable (controlling account).

Sales and Credit Tickets. Sales tickets must be made out for every sale and the daily total of these gives the total sales for the day. The cash sales tickets are checked against the cash received and the charge tickets go to the bookkeeper. Credit tickets must be made out to the credit of customers and these likewise go to the bookkeeper.

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*For complete discussion of petty cash fund, see page 203, "20th Century Bookkeeping and Accounting."

Ledgers. The general accounts should be classified in the general ledger in the following order:

1. Assets.
2. Liabilities.
3. Capital.
4. Income.
5. Expenses.

The accounts in the sales ledger represent trade customers. These are charged with merchandise sold on account, the bookkeeper securing his information from the sales tickets. These tickets are first listed, then turned over to the bookkeeper who posts them to the debit of the proper accounts listing the amounts as he posts them, then comparing his total with that of the first list which must agree. Credit entries for allowances, deductions, cash discounts, or returned goods are made from credit tickets in exactly the same manner. Posting to the ledger, therefore, comes from one of three sources:

1. Sales and credit tickets.
2. Journal.
3. Cash book.

The accounts in the purchases ledger represent trade creditors. These are credited with purchases on account and debited when paid. Allowances, deductions, cash discounts and returns are also debited to these accounts. The postings to these accounts may come from three sources:

1. Purchases book.
2. Journal.
3. Cash book.

Monthly Statements. Monthly statements will furnish information of inestimable value to the management and will also be available for comparative purposes. At least a Balance Sheet, Profit and Loss statement, and a comparative summary of sales and expenditures should be prepared. These statements do not involve a monthly closing of the books, which can be kept open until the end of the fiscal year or half year, it being quite customary in mercantile concerns to close the books semiannually, either December 31 and June 30, or January 31 and July 31, so as to divide the spring and fall seasons.

In the following pages are shown pro forma statements. These statements, it will be noted, are similar in form to those prepared by the Federal Trade Commission and incorporated in "A System of Accounts for Retail Merchants."

PRO FORMA BALANCE SHEET

ASSETS			
CURRENT ASSETS			
Cash on Hand and in Bank.........		xxxx.xx	
Notes Rec. (Trade Customers)......		xxx.xx	
Accounts Rec. (Trade Customers)...	xxxx.xx		
Less Reserve for Bad Debts.......	xx.xx	xxxx.xx	
Inventory of Merchandise (at cost)...		xxxx.xx	
Prepaid Insurance..................		xxx.xx	
Accrued Interest Receivable.........		.xx	
Total Current Assets.............			xxxx.xx
FIXED ASSETS			
Store Property.....................	xxxx.xx		
Warehouse Property...............	xxxx.xx		
	xxxx.xx		
Less Reserve for Depreciation on Store and Warehouse.........	xx.xx	xxxx.xx	
Store Equipment..................		xxx.xx	
Office Equipment..................		xx.xx	
Delivery Equipment...............		xxx.xx	
Total Fixed Assets...............			xxxx.xx
Total Assets...............			xxxxx.xx
LIABILITIES AND CAPITAL			
CURRENT LIABILITIES			
Notes Payable (Trade Creditors)....	xxxx.xx		
Notes Payable (Banks).............	xxx.xx		
Accounts Payable (Trade Creditors)..	xxxx.xx		
Accounts Payable (Others)..........	xxx.xx		
Accrued Interest Payable...........	xx.xx		
Accrued Salaries and Wages.........	xx.xx		
Accrued Taxes.....................	x.xx		
Total Current Liabilities..........		xxxx.xx	
FIXED LIABILITIES			
Mortgages Payable (Warehouse).....		xxxx.xx	
Total Liabilities...........		xxxx.xx	
Proprietor's Capital Account........		xxxx.xx	
Total Liabilities and Capital.			xxxxx.xx

(EXHIBIT "A")

(NOTE. In the above statement, it is evident that the Depreciation on Store, Office and Delivery Equipment has been credited directly to the asset accounts, instead of crediting specific reserves for depreciation. This is frequently done with regard to equipment accounts. In case specific reserves were set up, they should be deducted from the book value of the assets on the Balance Sheet.

If the business was organized as a partnership, each partner's capital should be shown individually. If the business was organized as a corporation, the amount of capital stock outstanding should be shown. The remainder of the Net Capital would appear as Undivided Profits or Surplus.)

PRO FORMA PROFIT AND LOSS STATEMENT

				Per cent.	
Sales			xxxx.xx		
Less Sales Allowances			x.xx		
Net Sales			xxxx.xx		100.
Inventory of Merchandise at beginning		xxxx.xx			
Merchandise Purchases (cost delivered at store)		xxxx.xx			
		xxxx.xx			
Deduct Inventory of Merchandise at Closing	xxxx.xx				
Less Stock Depreciation	xxx.xx	xxxx.xx			
Net Cost of Goods Sold			xxxx.xx		xx.x
Gross Profit from Trading			xxxx.xx		xx.x
Buying Expense					
Salaries and Wages of Buying Force	xx.xx				
General Buying Expense	xx.xx				
Total Buying Expense		xx.xx		.x	
Selling Expense					
Salaries and Wages of Sales Force	xxx.xx				
Advertising	xx.xx				
General Selling Expense	x.xx				
Total Selling Expense		xxx.xx		x.x	
Delivery Expense					
Salaries and Wages of Delivery Force	xxx.xx				
General Delivery Expense	x.xx				
Total Delivery Expense		xxx.xx		x.x	
General Expense					
Management and Office Salaries	xxx.xx				
Office Supplies and Expense	xx.xx				
Insurance	x.xx				
Taxes	x.xx				
Losses from Bad Debts	xx.xx				
Rent	xx.xx				
Miscellaneous General Expense	xx.xx				
Total General Expense		xxx.xx	xxx.xx	x.x	xx.x
Net Profit from Trading			xxx.xx		xx.x
Income From Other Sources					
Interest Earned		xx.xx			
Cash Discounts on Purchases		x.xx			
Rent Income (net)		xx.xx			
Miscellaneous Outside Income		x.xx	xx.xx		
Total Income			xxx.xx		
Deductions From Income					
Interest Cost		xx.xx			
Cash Discount on Sales		x.xx	xx.xx		
Net Profit			xxx.xx		

(EXHIBIT "B")

A. THEORY QUESTIONS

1. What general principles should govern a public accountant in the establishment of a system of accounts in any business? C. P. A. Ex.

2. Outline a system of internal check for a wholesale grocery concern doing a business of $3,000,000.00 a year, with about 2,000 customers. The system should co-ordinate with an annual audit by professional accountants. Inst. Ex.

3. Rule a cash book to provide for controlling accounts of debtors and creditors, also for discounts in settlement of both receivable and payable accounts; embrace also a method to include bank records. C. P. A. Ex.

4. In auditing department store A, you find that cash discounts on purchases are regularly deducted from invoices when they are entered in the books, while in store B, the invoices are entered in full and the discounts are credited to a discount account as and when received.

Discuss the relative advantages and disadvantages of the two methods, and state what variations, if any, would occur in the valuing of inventories under the two methods. Inst. Ex.

5. The proprietor of a mercantile store asked you to prepare a set of blanks to be used by them for checking all of their delivery wagons, including the returned goods which the driver, collected. He wants to be able to trace every package. Outline such a set. C. P. A. Ex.

B. ACCOUNTING PROBLEMS

1. In a certain department of a large dry-goods houses the purchases for a year were $30,000.00. They were in the first place marked up for "selling" purposes to $45,000.00. Later additional mark-ups amounting to $2,000.00 were made and mark-downs were also recorded aggregating $5,000.00. At the end of the fiscal period, there were found to be on hand goods of the marked selling value of $10,000.00.

State how you would ascertain their inventory value for the purpose of closing the books and calculate the amount. Explain fully. Inst. Ex.

2. The following Trial Balance was taken from the books of R. R. McClurg who conducts a retail mercantile business. It shows the accounts as of January 31, 1921, after the books had been closed and the net profit had been credited to the proprietor's capital account.

TRIAL BALANCE

January 31, 1921

Cash on Hand and in Bank	$ 3,223.34	
Notes Receivable (Trade Customers)	383.68	
Accounts Receivable (Trade Customers)	7,037.62	
Merchandise Inventory	5,818.12	
Prepaid Insurance	200.28	
Accrued Interest Receivable	1.42	
Store Property	9,000.00	
Warehouse Property	3,950.00	
Store Equipment	545.42	
Office Equipment	148.74	
Delivery Equipment	793.34	
Notes Payable (Trade Creditors)		$ 2,421.00
Notes Payable (Banks)		1,800.00
Accounts Payable (Trade Creditors)		7,371.44
Accounts Payable (Others)		970.00
Accrued Interest Payable		38.46
Accrued Salaries and Wages		164.00
Accrued Taxes		15.50
Mortgages Payable (Warehouse)		2,500.00
Reserve for Bad Debts		67.12
Reserve for Depreciation on Store and Warehouse		53.96
Proprietor's Capital		15,700.48
	$31,101.96	$31,101.96

Construct a Balance Sheet in accordance with the form illustrated on page 124.

3. An audit of the books of R. R. McClurg revealed the following information in addition to that shown in the above Trial Balance:

Merchandise Inventory, December 31, 1920	$6,902.18
Purchases	5,519.34
Sales	9,315.92
Sales Allowances	4.00
Stock Depreciation	306.22
Salaries and Wages of Buying Force	50.00
General Buying Expense	28.00
Salaries and Wages of Selling Force	354.66
Advertising	60.00
General Selling Expense	7.50
Salaries and Wages of Delivery Force	205.34
General Delivery Expense	16.16
Management and Office Salaries	538.00
Office Supplies and Expense	44.06
Insurance on Stock and Store Equipment	3.22
Taxes on Stock and Store Equipment	5.00

Losses from Bad Debts	$ 67.12
Miscellaneous General Expense	53.58
Rent	142.50
Interest Cost	34.18
Cash Discount on Purchases	13.10
Rent Income	33.04
Miscellaneous Outside Income	4.00

No physical inventory was taken on January 31. Neither had stock records been kept. The auditor has ascertained, however, that the average gross profit from trading for the previous three-year period has been 29 1/10%. You are, required:

(a) To calculate the inventory as of January 31, 1921.

(b) To prepare a Profit and Loss statement in form as illustrated on page 125.

4. Brown erects a business block at a cost of $100,000.00 At the end of the year he finds that the rents from the stores in the building amounted to $7,500.00; offices, $3,750.00. The expenses for the year were as follows:

Janitor, $750.00; repairs and alterations, $500.00; water and gas, $400.00; taxes, $1.97½ per $100.00, on an assessed valuation of $87,000.00; incidental expenses, $150.00.

Prepare statement showing results of the year's business and per cent. of profit on capital invested, charging 5% interest on investment and $2,500.00 for depreciation. C. P. A. Ex.

Chapter Nine

SYSTEMATIZATION (Continued)

DEPARTMENTAL ACCOUNTING

The previous discussion of an accounting system for a mercantile concern was based on the assumption that the volume of business was small and that it was not necessary to departmentalize the accounts. It was shown that a very simple set of records might suffice. All transactions might be recorded in but three books of original entry—the journal, cash book and purchases book, sales being recorded only on sales tickets, duplicates of which go to the bookkeeper. A single ledger might be sufficient, the accounts being subdivided into three divisions—general, creditors and customers. In a larger concern, the volume of business might make it advisable to subdivide the general ledger, subsidiary ledgers being provided for creditors and customers, controlling accounts for each being kept in the general ledger. In a very large mercantile concern, several ledgers might be provided for customers, the accounts being subdivided numerically, alphabetically or geographically.

Departmentalization. We shall now attempt to describe a system of accounts for a mercantile concern in which it is desired to show the results in various departments. In order that our discussion may be as definite as possible, we will assume a wholesale mercantile establishment of five different departments. It is desired to show the monthly results obtained in each department. The manager desires monthly operating and financial statements to be used as a basis in directing the affairs of the concern.

The Federal Trade Commission in "A System of Accounts for Retail Merchants" said with reference to departmentalization of accounts: "Any concern operating distinct departments can readily adjust the system to show the results obtained in each department."

No attempt is made to show how this adjustment may be made, hence it would seem to be so simple a procedure as not to require any further discussion. At any rate, no further reference is made to it in the Federal Reserve Bulletin. It is believed, however, that a discussion of the records, accounts and statements with emphasis on departmentalization of accounts will prove interesting and possibly enlightening to some who may not be familiar with departmental accounting.

Loose-Leaf Records. The system described and illustrated in the following pages is planned as a loose-leaf system. This form of record adds greatly to the elasticity of a system of accounting and is, in the long run, more economical than bound forms.

Voucher System. The voucher system is not often used in mercantile concerns, because these concerns find it preferable to carry individual accounts with creditors, whereas the voucher system is best adapted to concerns which pay their bills promptly and do not make payments on account, but pay each invoice in full. To attempt to operate a voucher system where numerous payments are made on account is to invite confusion; hence the system described hereinafter does not provide for the voucher system of handling invoices, though as stated, the voucher system would be entirely suitable for a concern that pays its bills promptly and in full as they mature.

Distribution of Expenses. When it is desired to departmentalize the accounts so as to show the results obtained in each department, it is necessary to provide for distributing all buying, selling and administrative expenses, both direct and indirect, to the proper departments.

Direct expenses represent expenditures which are incurred directly by or for a particular department or departments, hence these may be definitely charged to that department. Among the direct expenses may be classed wages of sales persons, salaries of department managers, insurance on merchandise in stock, departmental advertising and rent. It is customary to distribute the rent to departments on the basis of the floor space and position occupied by the department.

Indirect or overhead expenses (sometimes termed "burden") are expenditures incurred by and for the business as a whole. These are not direct charges to individual departments. They consist of administrative and general office salaries and expenses, general advertising, losses from bad debts, taxes, depreciation, etc., and are charged to nondepartmental expense accounts.

In the distribution of indirect expenses to the different departments, there are several methods in general use. (To be discussed in detail later). The most commonly used methods are:

(a) Net sales.
(b) Cost of sales.
(c) Direct labor.

Purchases Record. By reference to the illustration of Forms 101 and 101-A on the opposite page, it will be noted that forms have been devised on which all purchases and expenses are journalized and distributed by departments. In a large concern where there may be many departments, it would, of course, be advisable to separate the purchases and expenses providing separate books of account for each. In this concern with but five departments, the purchases and expenses may all be recorded and distributed in the same book.

Form 101 is the left hand page of the purchases and expense record, and it will be noted that columns are provided for recording the purchases of each department; while on Form 101-A, the right hand page, columns are provided for distributing the

Form 101

Record of Purchases and Expenses

Date of Invoice	L.F.	Account	Credit		Distribution of Purchases (Dr.)				
			Gen. Ledger	Pur. Ledger	Dept. A	Dept. B	Dept. C	Dept. D	Dept. E

(Left-hand page)

Form 101-A

Month of ....192....

Distribution of Departmental Expenses (Dr.)					Gen. Administrative Expenses		General (Dr.)		
Dept. A	Dept. B	Dept. C	Dept. D	Dept. E			Account	L.F.	Amount

(Right-hand page)

departmental expenses. All invoices, whether they represent purchases or expenses, must be journalized in this record. All items appearing in the general ledger column would, of course, be posted to the credit of the proper account in the general ledger. The total of the purchases ledger column at the end of each month would be posted to the Purchases Ledger controlling account in the general ledger, the individual items having been posted to the accounts with creditors in the purchases ledger. The total of the purchases distribution columns will be posted to the proper departmental purchases account.

Freight In. Freight paid on purchases adds to the cost of material purchased and, strictly speaking, should be distributed over the individual items purchased in order to arrive at their true cost. However, in most mercantile businesses, it is out of the question to attempt to distribute the freight over the individual items. The freight may easily, however, be distributed by departments and this should always be done where the freight amounts to any considerable sum. Its further distribution must depend upon circumstances.

Invoices for freight charges should be recorded on the left hand page and distributed by departments the same as purchases. However, it will probably be best to open separate accounts with Freight In for each department. If this is done, it will be necessary to analyze the columns at the end of the month and post the freight charges separate from the purchases. This will not be difficult, and, if desired, freight charges might be entered in ink of a distinctive color during the month so that it would be a very simple procedure to analyze the entries for the month, posting freight charges to the proper departmental Freight In account, and the balance to the proper departmental Purchases account. If desired, additional columns might be provided for distributing freight on purchases by departments. This would avoid the necessity of analyzing the items before posting the totals of the departmental purchases columns.

Only one expense column for each department and only one general expense column has been provided. If it were attempted to provide separate columns for each kind of expense in each department, the book would be too cumbersome to be practical. The number of expense entries in one month will not be very great, and anyone familiar with the bookkeeping can make an analysis of the entries in a short time. This analysis should be made at the end of the month and to correspond with the general ledger accounts with expense. The postings to these accounts will be made from the analysis in total. The details of this analysis may be written just below the footings for the month so that there may be a permanent record serving as a connecting link between the expense columns and the general ledger.

If desired, the departmental expense accounts can be carried on a special ruled ledger form. As many columns as may be necessary may be provided and one expense account can be carried in each column. There should also be a total column so that the total expenses for the department will appear in one column. This should prove with the corresponding column on the original record where the distribution is made. By providing such a special ruled ledger form, one sheet can thus be made to carry all the expense accounts of one department. A blank column is provided on Form 101-A for use as desired. A general ledger debit column is provided for recording any transactions that cannot be distributed to any of the other debit columns.

Sales Record. Form 102 on next page represents a sales ticket to be used by sales persons in recording all sales, whether cash or credit. This is a very simple form of sales ticket. At the end of each day, the cash sales tickets will be totaled and proved with the cash receipts. Account sales tickets will go to the individual bookkeepers. Each sales person may be required to make a recapitulation of sales for the day, this recapitulation to be turned in to the department manager at the end of the day. The department manager may be required to prepare a recapitulation of sales for the department, this to go to the head office.

Abstract of Sales. At the end of each month, an abstract of cash and credit sales should be made on Form 102-A. This shows the total sales both on account and for cash with a proper distribution by departments. Note also that a Freight Out column is provided so that freight paid on merchandise sold and charged to the customer's account will not be included in the sales distributed to departments. Freight charges are not a part of sales and should not be included with the sales, but are included in the amount charged to the customer's account. This provision is, of course, required only in case it is a practice of the concern to charge the customer with any delivery expenses. In the larger cities, retail mercantile establishments in some cases have found it more economical to make all deliveries by Parcel Post mail, thereby doing away with all delivery equipment. However, it is usually the custom of the concern to make the delivery without charge to the customer, in which case all of the delivery expenses are to be classed as selling expenses and should not be charged to the customer's account. It is only when these expenses are charged to customers that a column for Freight Out would be required on the Abstract of Sales form.

General Cash Book. If the volume of business is such as to make it advisable to separate the cash book, this can be done by simply keeping cash receipts in one record and cash payments in another. The rulings would be the same whether receipts and payments are kept separate or whether they are bound in one book. Form 103 is devised for recording all cash

Form 102

Sales Ticket

Sold To.. No.............

Address.. Date.............

Terms:

Quantity	Description of Articles	Price	Total

Abstract of Sales

Form 102-A

Month of ....192....

Sales		Freight Out (Cr.)	Distribution (Cr.)				
On Account	Cash		Dept. A	Dept. B	Dept. C	Dept. D	Dept. E

receipts. A general ledger and a sales ledger column are provided. All items appearing in the general ledger column will be posted individually to the proper accounts. The total of the sales ledger column will be posted to the credit of the Sales Ledger controlling account in the general ledger, the individual items having been posted to the proper accounts in the sales ledger. The total of the discount column is posted to the debit of the Discounts on Sales account in the general ledger. The total of the cash sales column is posted to the Cash Sales account in the general ledger, provided a separate account is maintained, otherwise it is posted to Sales account. A total receipts column and a bank deposits column are provided and it is recommended that in all cases the practice of depositing all receipts be followed. If this is done, the total of the receipts and deposits columns at the end of the month will be equal. It will not be necessary to carry a bank account in the general ledger, for the difference between the bank deposits column and the checks column, on Forms 103 and 103-A, will be equal to the cash balance provided, of course, that on the last day of the month all receipts are deposited before the cash book is ruled and footed. The total of the receipts column should be posted to the debit of the Cash account in the general ledger and it is recommended that a cash account be kept so that the general ledger will balance independently of all other records, and the bookkeeper will thus be able to take a Trial Balance off the general ledger without reference to any of the other books of account.

Form 103-A is for cash payments. General ledger and purchases ledger columns are provided. All items entered in the general ledger column will be posted to the debit of the proper accounts in the general ledger. The total of the purchases ledger column will be posted to the debit of the Purchases Ledger controlling account in the general ledger, the individual items having been posted to the proper accounts in the purchases ledger. The total of the discount column will be posted to the credit of the Discount on Purchases account in the general ledger. It is not necessary to provide a column for total payments because if all payments are made by check, the total of the check column will be the total payments for the month. Two blank columns are provided for use as may be necessary.

General Journal. Form 104, shown on page 138, indicates the ruling of the journal. Special columns are provided for the general ledger and for subsidiary ledgers with purchases and sales. Debit and credit columns are provided for each ledger. If preferred, three columns might be shown to the left and three to the right of the explanation column; the ones on the left being provided for all debits and the ones on the right for credits. Both forms are in general use, and it is only a matter of preference as to which is desired. All transactions not to be recorded in the other books of original entry should be recorded in the general journal. At the end of the month, all adjusting entries would be recorded in the journal, and at the end of the fiscal

Form 103

Cash Receipts

Date	L.F.	Account	General Ledger (Cr.)	Sales Ledger (Cr.)	Discount On Sales (Dr.)	Cash Sales (Cr.)	Total Receipts	Bank Deposits

Form 103-A

Cash Payments

Date	L.F.	Account	General Ledger (Dr.)	Purchases Ledger (Dr.)	Discount on Purchases (Cr.)			Total Payments (by Check)

year, when the books are closed, closing entries would be recorded in the general journal.

Stock Ledger. Form 105 is provided for keeping a going inventory of merchandise. If monthly statements are to be prepared, it will be necessary to ascertain the inventory on the last day of each month. It it were necessary to take a physical inventory in order to do this, the labor required might be so great as to make it practically out of the question to attempt to prepare monthly statements. This is, of course, only one reason for keeping stock records. The prime object of a book inventory is not to supersede a physical inventory, but to supplement it and to provide at the end of each month, or as often as may be desired, the value of the stock which should be on hand at that particular time. Annually or oftener physical inventories should be taken and compared with the book inventories at which time the book inventories should be adjusted. The accuracy of book inventories will depend largely upon the person or persons in charge of the records. With a careless person in charge, there may be a very great differentiation, while if as much care is used in keeping the book inventories as is used in keeping a record of cash, accurate results may be obtained.

The methods of keeping stock records in arriving at book inventories differ in detail according to the nature and size of the business. Special methods have sometimes been adopted within the same business for certain departments, but as a rule, stock records are kept on one of the following bases:

(a) Cost basis.
(b) Cost and retail basis.
(c) Retail basis.

The form of stock ledger sheet illustrated provides for showing quantity and value. In some concerns, it is only necessary to provide stock sheets showing quantity. If the form illustrated is used, it will not be necessary to calculate the cost of each sale, as all information regarding cost will be derived from the stock book. Of course, the cost of sales can be calculated only at the close of each period, while if the individual sales are costed and the cost carried to the sales abstract daily, there is nothing left to be done at the close of the period excepting to foot the abstract of sales.

Form 105 will show complete financial information on every line of merchandise. Three divisions are shown—receipts, sales and balance. The first entry in the receipts division will be to record the inventory at date of opening the books. Purchases during the period will be entered at cost, the information being obtained direct from the invoices. All sales will be entered in the sales division, the information being obtained from the sales tickets. If a monthly statement is required, every account in the book must be footed and balanced and the balance extended in the balance division at the end of each month. In

Form 104

General Journal

L.F.	Account	General Ledger		Purchases Ledger		Sales Ledger	
		(Dr.)	(Cr.)	(Dr.)	(Cr.)	(Dr.)	(Cr.)

Form 105

Stock Ledger

Stock............................ Minimum.............. Maximum.............. Sheet No.........

Receipts					Sales				Balance (Average Cost)				Remarks
Invoice No.	Date	Quan-tity	Unit Cost	Total Cost	Date	Sale No.	Quan-tity	Sales Price	Date	Quan-tity	Unit Cost	Total Cost	

the quantity column will be entered the difference between the total quantity received and the total quantity sold. In the unit cost column will be found the average cost per unit which is found by dividing the footings in the total cost column in the receipts division by the footings in the quantity column in the receipts division. This average unit cost will then be multiplied by the quantity on hand and the result carried into the total cost column of the balance division. After the stock ledger has been footed and balances extended at the end of the month, an abstract for each article may be prepared showing:

(a) Total receipts to date (total cost column, receipts division).

(b) Total sales to date (sales price column, sales division).

(c) Total cost of stock on hand (total cost column, balance division).

Adding machines may be used for such calculations. Otherwise the work would prove burdensome.

The total receipts as shown by the abstract should agree with the purchases as shown in the ledger, and the total sales as shown by the abstract should agree with the sales shown in the ledger.

To ascertain the gross profit from the information given on the abstract, to the total sales to date add the total cost of stock on hand and subtract the total receipts to date. To ascertain the cost of sales, subtract the gross profit from the total sales to date.

Installment Sales. In some lines of business it is customary to sell merchandise on the installment plan. Title usually does not pass to the purchaser until the final installment has been paid. It is customary to charge the full contract price to the customer at time of sale. There are two methods of accounting for the profits on such sales.

1. Contract sales may be treated the same as actual sales and the Sales account may be credited at the time the contract is made, and the amount charged to the customer. In this case, a reserve should be provided equal to the anticipated loss on deferred installments. The amount of the reserve will depend largely upon the character of the merchandise sold. Since the dealer holds title to the merchandise until final installment is paid, he can take the merchandise back in case of failure to make payments as agreed, and the amount of loss may be practically nothing, the actual loss being the difference between the amount charged to the customer on the contract and the amount collected in installments, plus the amount realized by the resale of the merchandise after having been taken back. This loss should be charged to the reserve account.

2. Installment Sales account may be credited at the time the customer is charged for the amount of the contract. As each installment is paid, an entry is made in the cash book debiting Cash and crediting Customer for the amount received.

At the same time an entry is made crediting Sales and debiting Installment Sales. Thus, when the final installment has been paid, the accounts with the Customer and Installment Sales will balance. The Cash account will show the receipts and the Sales account will show the amount of the sales to date. The balance of the Installment Sales account is a deduction from Accounts Receivable on the Balance Sheet. It is not necessary to set up a reserve for loss on the deferred payments. It is necessary, however, to calculate the profit on each installment sale before preparing the Profit and Loss statement.

Branch Store Accounting. Mercantile concerns often operate one or more branch stores. These may be located in the same or other cities. A complete set of books may be kept in each store, or the accounting may all be done at the main store. If the accounting is all done at the main store, the system will be similar to a departmental system, it being necessary to show results of operations of each store.

A controlling account only may be kept on the books at the main store containing a summary of the transactions with the branch store. The account may be debited with the inventory of property on hand when the books are opened, or when the store is established. In other words, the account would be debited for the total assets of the branch store. Subsequently, the account should be debited for:

(a) Merchandise transferred to the store from the main store.

(b) Merchandise or other property purchased and shipped direct to the branch store.

(c) All branch store expenses including wages paid employes.

The account should be credited for amounts received from the sale of merchandise. Usually the branch store manager remits only in cash as he collects on the sales. At the close of the fiscal period, the account would be credited for the inventory of merchandise and other property on hand.

If the Branch Store account is debited with the cost price of the merchandise transferred to it or purchased for it and is credited with the returns, which will usually be in cash, it will be seen that the balance, after having made the necessary adjustment for the closing inventory, will represent the profit or loss resulting from the operations of the branch store. If desired, instead of opening a single controlling account, special accounts might be kept with Branch Store Inventory, Branch Store Purchases and Branch Store Sales. The inventory account would not only contain the merchandise on hand, but would also contain the fixed assets and current assets of the store; though if desired, these could be kept in separate accounts, leaving the inventory account for merchandise only.

Another plan that is widely followed is to charge the branch store with merchandise at retail prices. If the Branch Store account should be charged with the beginning inventory at retail price with merchandise transferred to the store or purchased for the store during the period at retail prices, and was credited with the inventory on hand at the end of the period at retail price, it can readily be seen that the balance of the account will represent the returns from sales at the branch store. When the account is credited with the returns from the branch store, it will balance.

To ascertain the profit, it will be necessary to take into consideration the cost of the merchandise previously charged to the Branch Store account. One advantage of this method is that the branch store manager will not know the results from operating the store. Since he does not know the cost of merchandise charged to his store, he cannot ascertain the profits resulting from his sales.

ACCOUNTING PROBLEMS

1. Outline a system of books for a concern conducting a wholesale drug house, a retail pharmacy, and a jobbing business in chemicals and apparatus used by colleges. Some setting up and repairing of apparatus is done, and so a shop is conducted. Four departments required and but one set of books.

C. P. A. Ex.

2. R.L.Eames has a chain of five retail grocery stores. Goods are sold to consumers for cash, and to small dealers on credit. Additional working capital is required. Three of Eames' friends agree to furnish funds providing the business is incorporated. Such books as exist have been kept by single entry. The business is duly incorporated for an authorized capital of $100,000.00, par value of shares $100.00 each. It is agreed that Eames shall turn over his business to the company as at July 1, 1920, on appraised values of physical properties; and values of all book accounts (assets and liabilities) as they shall be disclosed; and Eames' net worth is to apply on his stock subscription of $25,000.00. In addition, Eames is to be allowed 25% of the net worth for good will. Other capital stock subscriptions are, respectively:

W. G. Mee	$30,000.00
H. B. Immel	25,000.00
H. Frazier	20,000.00

and each is to pay immediately in cash a proportionate amount on subscription which, altogether, shall aggregate 50% more than the value of capital stock issued to Eames.

The Union Appraisal Company reports as follows:

Real Estate:

Store No. 1	$4,000.00
Store No. 2	5,000.00

Buildings:	Reproductive Values	Sound Values
Store No. 1	$3,000.00	$2,000.00
Store No. 2	7,500.00	5,000.00
Furniture and Fixtures:		
Stores	10,000.00	7,500.00
General Office	1,000.00	500.00
Stock Room	1,000.00	500.00
Automobiles (2)	5,000.00	3,500.00

Inventories (Merchandise):		
In Store Room		14,000.00
In Storage (Butter and Eggs)		5,000.00
In Stores		11,000.00
No. 1	$2,300.00	
No. 2	1,950.00	
No. 3	3,135.00	
No. 4	2,365.00	
No. 5	1,250.00	

The book accounts disclosed are as follows:

Cash at Bank		$1,500.00
Cash—General Office Petty Cash		100.00
Cash—Stores		500.00
No. 1	$140.00	
No. 2	75.00	
No. 3	160.00	
No. 4	60.00	
No. 5	65.00	
Accounts Receivable—Dealers		$2,600.00
Trade Creditors' Accounts		22,280.00
Accrued Wages and Salaries		795.00
Accrued Taxes		100.00
Unexpired Insurance		50.00
Mortgage on Real Estate and Buildings—dated July 1, 1919; principal payable in 5 years; interest at 6% per annum, payable semiannually		7,500.00
Notes Payable (Bank):		
Due 3 months from May 1, 1920 (6%)		10,000.00
Due 3 months from June 1, 1920 (6%)		5,000.00

Interest falling due on mortgage loan has not been paid. Interest on the $10,000.00 note is payable at maturity. The $5,000.00 note was discounted.

The following additional facts are shown on the books and records of the R. L. Eames Company at the close of the first month's business:

Merchandise Purchases (of which $750.00 was returned)		$35,000.00
Stores' Sales as per Cash Register Totals:		
Store No. 1	$6,000.00	
Store No. 2	3,500.00	

Store No. 3	$8,000.00	
Store No. 4	5,000.00	
Store No. 5	2,500.00	
Sales to Dealers		$5,000.00
Issues from General Stock (at cost):		
Store No. 1	$5,585.00	
Store No. 2	2,850.00	
Store No. 3	6,470.00	
Store No. 4	4,210.00	
Store No. 5	2,475.00	
Cost of Goods Shipped to Dealers		4,545.00

Expenses of Stores:	Clerks' Wages	Rents	Heat, Light, Cleaning, Ice, etc.	
Store No. 1	$200.00	$65.00	$25.00	$290.00
Store No. 2	135.00	25.00	20.00	180.00
Store No. 3	235.00	75.00	35.00	345.00
Store No. 4	200.00	150.00	35.00	385.00
Store No. 5	135.00	100.00	35.00	270.00

Management and Office Salaries	$385.00
Store Room and Delivery Wages	265.00
Rent of Office and Store Room	35.00
Stationery and Office Supplies	40.00
Postage	10.00
Advertising	75.00
Freight In	50.00
Heat, Light, and Janitor (Office)	15.00
Appraisal and Audit Fees	350.00
Law and Organization Expenses	250.00
Auto Up-Keep	90.00
Telephone	40.00

Debts of R. L. Eames not disclosed at date of turnover:		
On Creditors' Accounts	$675.00	
On Storage Charges (of which $5.00 is for current month)	20.00	695.00

The stores' merchandise inventories at the end of the month amount to:

Store No. 1	$2,650.00
Store No. 2	1,875.00
Store No. 3	2,920.00
Store No. 4	2,115.00
Store No. 5	940.00

The stores' cash funds are reduced to:

Store No. 1	$100.00
Store No. 2	50.00
Store No. 3	100.00
Store No. 4	50.00
Store No. 5	50.00

Differences are found in the stores' cash funds at the close of the first month's business:

Store No. 1	short	$ 3.00
Store No. 2	over	1.00
Store No. 5	over	17.00

The general merchandise stock shows:

Spoiled Goods	$60.00
Shortage in Inventory at the End of the Month	35.00

The stores receive credit for spoiled goods:

Store No. 1	$15.00
Store No. 2	10.00
Store No. 3	20.00
Store No. 4	15.00
Store No. 5	30.00

The upper floor of Store No. 1 building is tenanted, and rentals at $25.00 monthly, payable in advance, are found to be three months in arrears, of which $50.00 is paid during July.

Insurance expires September 30, 1920. All salaries and wages are payable one-half each on the 1st and 15th of the month.

Dealers have paid on their accounts, $4,200.00. Trade creditors have been paid (of which $340.00 is discount) $40,000.00.

Depreciation charges (annual rates):

On Buildings, 5%.

On Furniture and Fixtures, 10%.

On Automobiles, 25%.

Part of Store No. 2 building is used for the general office and store room.

You are asked to submit:

(a) Opening entries on the books of the corporation (journal form with brief explanations), taking over the business of R. L. Eames and including payments on account of capital stock subscriptions.

(b) General Cash account for the month.

(c) Profit and Loss statement for the month, showing also, in a clear and simple manner, the stores' operations with percentages of gross profit on cost. It is not necessary to prorate any of the general business expenses to the stores.

(d) Comparative Balance Sheet as at July 1 and July 31, 1920.

(e) A brief statement giving the grounds of your conclusions in explanation of the loss on goods sold in Store No. 5.

C. P. A. Ex.

Chapter Ten

SYSTEMATIZATION (Continued)

FLOUR MILL ACCOUNTING

To continue the discussion of the fundamental principles of systematization and to further outline the accountant's work in connection with the installation of an accounting system, the present discussion will be confined to a system of accounts adapted to a specific concern. We will first describe briefly the organization of the concern to which the system is to be adapted, as well as the purpose of the accounting system to be installed.

The Edgerton Milling Co. is organized as a corporation with a capital stock outstanding of $50,000.00. Wheat and other grains are purchased direct from farmers and from elevators. Flour, feed and other products are sold direct to farmers at retail prices, to merchants at wholesale, and also to jobbers.

Heretofore, the company has been satisfied with a crude system of accounts which might be termed a "single entry" system. They were not able to arrive at costs accurately, but determined selling prices by arbitrary methods. To ascertain true costs, to obtain needed statistics, and to prepare income and excess profits tax returns more intelligently, it has been decided to call in a certified public accountant for the purpose of installing a suitable system of accounts.

In a preliminary investigation of the various phases of the flour mill industry, the following facts were ascertained.

(1) The raw material upon which the industry depends is produced in seasons, thus involving periods during which no grain is available, and in the event of complete or partial crop failures, a regional shortage; therefore, in order to insure a steady in-flow of grain for milling purposes, contracts of purchase are made for future delivery.

(2) The product of the flour mill is a necessity for which there is a constant and continuous demand. In order to insure a steady out-flow of flour through the system of distribution, it is necessary to enter into contracts of sale for future delivery.

(3) The trading in "futures" involves what might be termed "speculation." While the conservative miller avoids gambling as much as possible, there are millers who combine the speculative feature with their milling business.

(4) In grain growing regions, farmers find it convenient to deliver the grain to a miller and purchase flour and offal (feed). This custom has resulted in what is termed an "ex-

change." The miller exchanges his products for the raw material of the farmer, allowing the farmer the current market price for grains and charging the selling price for flour and feed. This exchange feature has led to the development of numerous small country mills which will probably continue to exist indefinitely, regardless of the competition from large and growing companies.

(5) The cost of raw material forms the principal part of the selling price. This cost varies from 75 to 80 per cent. of the sales price of patent flour.

(6) To produce a particular brand of patent flour, the miller purchases wheat of proper grades and kinds so as to maintain a constant mixture of such grades and kinds of wheat as will produce the desired brand.

(7) Generally speaking, about 4½ bu. of wheat are required for a barrel of flour (196 lbs.), while a by-product of approximately 74 lbs. of offal is divided between various grades of feed known as screenings (red dog), middlings, brans and shorts.

(8) In sacking the flour, various sizes and kinds of sacks are used, ranging in content from 6 lbs. to 140 lbs.

(9) The milling industry is such that it may be classed with the so-called "by-product industries," in which the production of one article (flour) is attended by the production of certain by-products (offal).

(10) A peculiar system exists in the milling industry for charging freight. The miller purchases wheat for shipment to his mill, paying the local freight rate from point of purchase to the mill. The flour is then milled and shipped at the through rate from point of original purchase to selling point, credit being extended by the carrier against the rate computed at the through rate for the amount already paid at the local rate from point of purchase to the mill. This is known as a "milling-in-transit" privilege and may result in a saving of from ten to twenty-five cents per barrel of flour, hence is an important item to the country miller.

Outline of Accounts. The following outline of accounts was prepared by the accountant preliminary to devising the books of account. Note the system used for numbering the accounts. This system can be carried out regardless of the number of accounts to be kept. If a classification of accounts is to be of the most service, it should have a system of account numbers, and an arrangement of accounts that will permit the addition of new accounts at any point, as the necessity arises, without disturbing the general scheme or order. The Dewey system of numbering, or a combination of numbers and letters, permits the greatest flexibility, provided tabulating machinery is not used.

OUTLINE OF ACCOUNTS

1. Assets.

  11 Current assets.

    111 Cash.
    112 Accounts receivable.
      1121 Customers' ledger.
      1122 Reserve for bad and doubtful accounts.
    113 Notes receivable.
    114 Inventories.
      1141 Flour.
      1142 Offal.
      1143 Other products.
      1144 Wheat.
      1145 Flour packages.
      1146 Offal packages.
      1147 Mill supplies.
    115 Temporary investments.
    116 Options.

  12 Deferred assets.

    121 Insurance prepaid.
    122 Expenses prepaid.
    123 Milling-in-transit.

  13 Fixed assets.

    131 Land.
    132 Mill.
      1321 Mill buildings.
      1322 Reserve for depreciation.
      1323 Mill equipment.
      1324 Reserve for depreciation.
    133 Office.
      1331 Building and equipment.
      1332 Reserve for depreciation.
    134 Storage and delivery.
      1341 Building and equipment.
      1342 Reserve for depreciation.
    135 Permanent investments.
      1351 Bonds.

  14 Special assets.

    141 Contracts for future delivery—flour.
    142 Contracts for future delivery—offal.

  15 Contingent assets.

    151 Claims.

2. Liabilities.

  21 Current liabilities.

    211 Accounts payable.
    212 Notes payable.
    213 Accrued liabilities.
      2131 Taxes.
      2132 Interest.
      2133 Wages.

OUTLINE OF ACCOUNTS

- 22 Fixed.
  - 221 Mortgage payable.
  - 222 Bonds.
- 23 Contingent.
  - 231 Notes receivable discounted.
  - 232 Claims.
- 24 Special.
  - 241 Contracts for future delivery.

3. Proprietorship.
   - 31 Capital stock.
   - 32 Unappropriated surplus.
   - 33 Appropriated surplus.
     - 331 Reserve for contingencies.
     - 332 Reserve for sinking funds.
   - 34 Profit and loss—current year.
     - 341 Dividends.
     - 342 Income and excess profits taxes.
     - 343 Appropriations of net profits.

4. Revenues.
   - 41 Sales.
     - 411 Flour.
     - 412 Returns and allowances on flour sales.
     - 413 Offal.
     - 414 Returns and allowances on offal sales.
     - 415 Freight outward.
   - 42 Gains on options.
   - 43 Other income.
     - 431 Interest.

5. Expenses.
   - 51 Cost of sales.
     - 511 Milling.
     - 512 Packages.
       - 5121 Flour.
       - 5122 Offal.
   - 52 Selling.
     - 521 Salesmen's salaries.
     - 522 Traveling expenses.
     - 523 Commissions.
     - 524 Advertising.
     - 525 Bad debts.
   - 53 Warehouse and delivery.
     - 531 Salaries.
     - 532 Other expenses.
     - 533 Depreciation.
   - 54 Administration.
     - 541 Office salaries.
     - 542 Office expenses.
     - 543 Depreciation.
   - 55 Interest and exchange.
   - 56 Loss on options.

Books of Account. There follows illustrations of the various books of original entry devised by the accountant, together with a detailed description of each book and instruction for its use.

Record of Purchases. (Forms 201, 201-A and 201-B) Either a loose-leaf or bound book may be used for a record of purchases. In the illustration, we have subdivided the record assuming that it would be better to use two pages rather than to attempt to get all the desired information on a single page. The purpose of this record is to record the quantity and amount of all goods purchased, whether raw material for milling, supplies representing expense items, or equipment representing fixed assets.

The desired information may be obtained from the invoices received or from reports of material receipts. When raw material is purchased direct from farmers, no invoice will be received, hence it will be necessary to provide a record of material receipts. This form is to be used in recording receipts of all material from farmers and may be used in recording all other receipts of raw material. The material received can then be checked against the original invoices.

The total amount of the invoices should be recorded in the first money column. Each item in this column should be posted to the individual creditor's account in the accounts payable ledger. At the end of the month, the total of the column should be posted to the credit of the Accounts Payable Controlling account in the general ledger. If it is not desired to keep an account with persons from whom material is purchased for cash, the item may be checked in both the purchases and cash books, indicating that it should not be posted to the individual's account.

The material purchased should be distributed to the various columns provided therefor. The amount of wheat purchased should be entered in the columns headed Wheat, recording both quantity and amount purchased. Flour and feed sacks and other commodities should be distributed similarly in the columns provided. At the end of the month, these columns should be totaled and posted to the debit of the proper accounts with materials in the general ledger. These accounts will represent inventory accounts. In posting other commodities, it will be necessary to analyze the items so that the posting will be to the proper accounts.

Manufacturing, administrative and selling expenses should be analyzed and charged in detail to the proper accounts. Fixed assets and other items that cannot be classified in the preceding columns should be recorded in the columns headed Sundries. These items should be posted individually to the proper accounts in the general ledger. At the end of the month, the total of the debit columns should equal the total of the credit columns.

Form 201

Record of Purchases

Date	From Whom Purchased	INVOICE			WHEAT		SACKS	
		No.	Terms	Amount (Cr.)	Quantity	Amount (Dr.)	Flour (Dr.)	Feed (Dr.)

(Left-hand page)

Form 201-A

Record of Purchases

Other Commodities		Mfg. Expenses		Adm. & Sell. Exp.		SUNDRIES	
Account	Amount (Dr.)	Account	Amount (Dr.)	Account	Amount (Dr.)	Account	Amount (Dr.)

(Right-hand page)

Form 201-B

NAME

TERMS

Material Receipts Report

Edgerton Milling Co.

DATE 192

FOLIO

DESCRIPTION			COST		REMARKS
Article	Weight	Quantity	Rate	Amount	

Record of Cash Receipts. (Form 202) The object of this book is to provide a record of all cash received from whatever source. Columns are provided for General Ledger and Accounts Receivable Ledger accounts. All remittances from customers to apply on account should be recorded in the special column provided for the Accounts Receivable Ledger accounts. All individual items in this column should be posted to the individual customer's account in the accounts receivable ledger. At the end of the month, the total of the column should be posted to the credit of the Accounts Receivable controlling account in the general ledger.

Interest and exchange should be recorded in the column provided. At the end of the month, this column should be footed and the total posted to the debit of the Interest and Exchange account in the general ledger. Cash sales should be entered in the column provided. If cash sales are numerous, a special record may be provided and at the end of each day, the total may be recorded herein. At the end of the month, the total of the Cash Sales column should balance with the total of the Cash Sales column in the sales book.

Net cash received should be recorded in the special column provided in order to provide for an internal check by someone within the company or for an audit by a public accountant. The total cash received each day should be deposited in the bank. If this is done, the total of the cash received will equal the bank deposits at the end of the month, provided all money received has been deposited on the last day of the month. If desired, a petty cash fund may be kept. At the end of the month, the total of the debit columns should equal the total of the credit columns.

Record of Cash Disbursements. (Form 202-A) The object of this book is to provide a complete record of cash disbursements. It is needless to say that it is best to make all payments by check. Payments to creditors on account should be recorded in the Accounts Payable Ledger column. All individual items in this column should be posted to the individual creditor's account in the accounts payable ledger. At the end of the month, the total of the column should be posted to the debit of the Accounts Payable controlling account in the general ledger. Note that columns are provided for Interest and Exchange, Manufacturing Expense, and Administrative and Selling Expense. This eliminates considerable posting as it will not be necessary to post the individual items. At the end of the month, the columns may be footed and the totals posted to the proper accounts.

If all payments are made by check as suggested, it is not necessary to provide a Net Cash Paid column because the net cash paid will be shown in the Checks Issued column. At the end of the month, the total debit entries must equal the total credit entries.

Form 202

Cash Receipts

Date	ACCOUNTS	Gen. Led. (Cr.)	Accounts Rec. Led. (Cr.)	Int. and Exchange (Dr.)	Cash Sales (Cr.)			Net Cash Received (Dr.)	Bank Deposits

Form 202-A

Cash Disbursements

Date	ACCOUNTS	Gen. Led. (Dr.)	Accounts Pay. Led. (Dr.)	Int. and Exchange (Cr.)	Manufacturing Expenses		Adm. and Sell. Expenses		Checks Issued	
					Account	Amount (Dr.)	Account	Amount (Dr.)	No.	Amount

Record of Sales. (Form 203) The object of this book is to provide a complete record of all sales, whether for cash or on account. Every sale should be covered by an invoice. Account sales should be debited to the proper customer, the amount being recorded in the Account Sales column. The individual items in this column should be posted to the individual customer's account in the accounts receivable ledger. At the end of the month, the total of the column should be posted to the debit of the Accounts Receivable controlling account in the general ledger.

Cash sales should be entered in the first column. As has already been stated, if the cash sales are numerous and varied, a special record may be provided so as to eliminate the recording of a large number of small cash sales in this book. If this is done, the total cash sales for the day may be recorded in one amount. An analysis of the cash sales made will provide the information necessary to credit the respective sales accounts representing the various commodities sold.

All sales recorded in the first two columns should be properly distributed in the remaining columns. The distribution calls for the recording of kind, quantity and amount of each sale. With cash sales, this information may be obtained by an analysis. The required information may be obtained from the bill. (It is best that all billing be done in duplicate. In some instances, it may be equally satisfactory and even preferable to consider the carbon copies of the bills as the record of sales. The posting to the individual customer's accounts may be made direct from the bills and a recapitulation sheet may be provided in order that a proper distribution of the sales may be made. The recapitulation should show approximately the same information as will be shown on Form 203.) At the end of the month, the total debit entries must equal the total credit entries.

Order Book. (Form 203-A) Each order taken should be recorded in this book. The record should show the date the order was received, the name and address of the customer ordering, the quantity and kind of goods ordered, and the price at which the goods are to be billed. When the order has been filled and the goods shipped, this should be indicated on the order, and the customer should be billed. At the end of the month, the order book will show the orders on hand unfilled. It may happen that some orders have been filled in part but not completed and, therefore, not invoiced. In this case, the question arises as to whether or not a profit should be taken on the partly filled orders. If by "profit" is meant the excess of sales over the actual selling cost of sales, the firm would be justified in showing the profit on partly filled orders. If it is desired to show unfilled orders as a contingent asset, this should be offset by a contingent liability. If the orders unfilled are to be classed as assets, the milling company must also consider the liability existing on the unfilled orders.

Form 203

Record of Sales

Date	Accounts	Total Sales		Flour Sales			Offal Sales			Other Sales		
		Cash (Dr.)	Account (Dr.)	Kind	Quantity	Amount (Cr.)	Kind	Quantity	Amount (Cr.)	Kind	Quantity	Amount (Cr.)

Form 203-A

DATE OF ORDER		ORDER BLANK EDGERTON MILLING COMPANY	ORDER NO.	
SOLD BY			FOLIO	
FILLED BY		Sold to ________ Address ________	DATE BILLED	
DATE FILLED		Shipped via ________	TERMS	
Shipper's Check	Quantity	Items	Price	Amount

Form 204

Journal

Accounts Pay. Led. (Dr.)		Accounts Rec. Led. (Dr.)		Gen. Led. (Dr.)		ACCOUNT	Gen. Led. (Cr.)		Accounts Rec. Led. (Cr.)		Accounts Pay. Led. (Cr.)	

Journal. (**Form 204**) All entries that cannot be recorded in the special books of original entry should be recorded in the journal. Correcting and adjusting entries should be journalized and, at the end of the fiscal period, the nominal accounts in the general ledger should be closed by means of closing journal entries. Note that in this form of journal, there are provided debit columns at the left and credit columns at the right. Compare with the form of journal shown on page 138.

Stock Record. This book is provided for the purpose of keeping a perpetual inventory of all materials and products. Accounts should be kept with each kind of material, such as wheat, packages, etc., also with each product, such as flour, feed, etc.

The record should be divided into three parts—received or produced, consumed or sold, and balance on hand. The quantity and cost of material on hand should be recorded at the beginning of the period. This will be taken from the physical inventory. During the month, all purchases of material should be recorded, the information being obtained from the invoices and material receipts reports. If desired, the total purchases for the day may be entered in one item, using the average cost. The average cost may be found by dividing the total cost by the quantity. All material consumed must be recorded as to quantity, average cost, and amount. The information may be obtained from the Material Consumption Report. (See Form 205.) If material received and material consumed is properly recorded, it is only necessary to calculate the balance as to quantity and average cost in order to ascertain the inventory of material on hand at the end of the month.

The stock record of products such as flour and feed is equally important but more complicated. In order to acquire the desired information, it will be necessary to prepare daily production reports. (See Form 206.) These products are produced instead of being purchased; hence it is necessary to ascertain the cost of production in order to make a proper record of material produced as to quantity and cost. The cost

of production involves the cost of the raw material consumed, labor, both direct and indirect, and manufacturing expenses. (Inasmuch as the principles of cost accounting is the next topic to be taken up, a detailed discussion of the elements of cost of production will not be undertaken here.)

The accounts with products will be charged with the quantity produced and cost of production, and will be credited with the quantity sold at cost price, the difference being brought forward as a balance. If it is not desired to keep a record of products as to value but in quantity only, the record will be greatly simplified as it will only be necessary to charge the account with the quantity produced and credit it with the quantity sold, the difference being the balance on hand in quantity. For a small mill where a sound cost system is not in use, this will be best.

Material Consumption Report. (Form 205) The object of this report is to provide a record of material consumed daily as to quantity and cost. The quantity will be ascertained by weighing the grain consumed. Most mills are now equipped with automatic scales so that the grain is automatically weighed as it is milled. The cost of material consumed will be shown by the stock record. It will be best to assume that material received first is milled first, though if desired, the average cost may be used.

Production Report. (Form 206) The object of this report is to furnish a record of the quantity of all products produced daily. Columns are provided for each day in the week. These may be totaled and the total production shown at the end of the week. This will provide the necessary information for the stock record of products so far as quantity is concerned.

Ledgers. In addition to the general ledger, subsidiary ledgers for accounts with Customers and Creditors should be provided. No special rulings will be necessary. Controlling accounts for the subsidiary ledgers must be kept in the general ledger. At the end of each month, a schedule of the Accounts Receivable and Accounts Payable should be prepared and this should be compared with the balance of the controlling account. Any discrepancy should be located and corrected. If the subsidiary ledgers are to be made self-balancing, it will be necessary to provide a controlling account to be kept in each subsidiary ledger. This account will be similar to the controlling account in the general ledger except that it will be just the reverse, that is, it will be debited for all items appearing on the credit side of the controlling account in the general ledger, and will be credited for all items appearing on the debit side of the controlling account in the general ledger. The bookkeeper may then check the schedule of the individual accounts with the controlling account, without reference to the general ledger.

Form 205

DEPARTMENT	MATERIAL CONSUMPTION REPORT — EDGERTON MILLING COMPANY	NO. DATE 192

USED FOR		DESCRIPTION			COST	
Order No.	Article	Material Consumed	Weight	Quantity	Rate	Amount

Form 206

PRODUCTION REPORT

WEEK ENDING 192 NO.

Article		Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Total

A. THEORY QUESTIONS

1. In devising an accounting system for a business, what are the principal matters to be considered by the accountant, and in what order should they have attention? C. P. A. Ex.

2. Rule a form of cash book to provide for controlling accounts of debtors and creditors, for discounts in settlement of both receivable and payable accounts. What is the usual method of posting these figures? C. P. A. Ex.

3. You have been asked to prepare a system required for a clubhouse where rooms and board are furnished at a fixed rate per week. Submit a report to the directors outlining just what should be done, and what books and accounts would be needed. C. P. A. Ex.

4. In examining the affairs of a manufacturing concern you find, among the assets, finished goods inventory of $175,-798.00 and ascertain that included in the above total is the sum of $50,000.00 covering goods deposited as collateral to secure notes which are included in the Notes Payable account. How would you treat this in a statement prepared for credit purposes? Explain why. Inst. Ex.

5. A manufacturing concern asks you to certify to its average annual profits for the past five years. After charging all costs, expenses, and depreciation and allowances for bad debts, etc., it is found that profits for the first year were $30,-000.00; second year, $37,500.00; third year, $35,400.00; fourth year, $43,200.00; fifth year, $38,700.00.

Included in the second year's profits is profit on sale of real estate, $3,750.00; in third year's profits, $7,500.00 profit on investments; in fifth year's profit is $8,600.00 profit on real estate.

What would you certify as the average annual profit? Give reasons. C. P. A. Ex.

B. ACCOUNTING PROBLEMS*

1. From the Balance Sheet of the Lansdale Monotile Company dated December 31, 1920, together with the information following, show the Trial Balance before closing.

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* These problems constitute a review of the principles covered up to this point. If you have thoroughly mastered all the preceding work, you should experience no difficulty in solving them.

THE LANSDALE MONOTILE COMPANY
Balance Sheet—December 31, 1920

Assets			Liabilities and Capital	
Land & Bldgs.	$ 500,000		Capital Stock	$ 300,000
Less Res. for Depr.	120,000	$ 380,000	Notes Payable	350,000
Mach. & Equip.	$ 200,000		Accounts Payable	158,000
Less Res. for Depr.	80,000	120,000	Accrued Int. Payable	3,000
Cash		58,000	Surplus	314,000
U. S. Vict. B'ds		100,000		
Mdse. Inv.		125,000		
Accts. Rec.	$ 250,000			
Less Res. for Dbt. Accts.	12,500	237,500		
Notes Rec.		100,000		
Accr. Int. Rec.		4,500		
Total Assets		$1,125,000	Total Liabilities and Capital	$1,125,000

The accruals at the time of closing were: Interest on Notes Payable, $3,000; depreciation of buildings, $20,000; interest on Notes Receivable, $2,000; depreciation of machinery and equipment, $30,000; interest on Victory Bonds, $2,500; provision for doubtful accounts, $12,500. The other nominal accounts closed out were: Sales, $325,000; administrative expense, $50,000; cost of goods sold, $125,000; selling expense, $25,000. Inst. Ex.

2. THE PASSAIC FALLS WOOLEN MANUFACTURING CO.
Balance Sheet—June 30, 1920

Assets		Liabilities	
Land	$ 10,000	Cap. Stock, Com., par $100	$125,000
Buildings (brick)	100,000	Cap. Stock, Pfd., 7% cumulative, par $100	100,000
Machinery	150,000	Accounts Payable	130,000
Steam Power Plant	25,000	Undistributed Earnings (6-30-19)	60,000
Treasury Stock, Com., 250 shares costing	20,000	Profits, year ended (6-30-20)	35,000
Accounts Receivable	50,000		
Inventories (6-30-20)	75,000		
Cash	20,000		
Total Assets	$ 450,000	Total Liabilities	$ 450,000

Adjust the above figures in regard to the following:

(1) Land is appraised at $15,000 and is to be adjusted to that value. (2) Give effect in the statements to depreciation of 2½ % on the brick buildings, 7½ % on machinery, and 10 % on the steam power plant, for the year ended June 30, 1920, (3) Dividends on the preferred stock have not been paid for years ended June 30, 1919, and June 30, 1920. (4) Inventories are valued $5,000 below cost.

From the above Balance Sheet and data, prepare corrected Balance Sheet in appropriate form for the information of stockholders and auditor's certificate thereto, and show statement of adjustments to profits and surplus. Inst. Ex.

3. The Indiana Mining Company submits the following Trial Balance as of December 31, 1920.

Account	Dr. Amt.	Cr. Amt.
Cash on Hand	$ 74.50	
Cash in Bank	5,956.00	
Accounts Receivable	39,112.25	
Accounts Payable		$ 12,500.00
Notes Receivable	15,000.00	
Capital Stock		100,000.00
Surplus		67,709.35
Buildings and Machinery	145,000.00	
Office Building	5,000.00	
Blacksmith Shop	4,000.00	
Inside Construction	15,675.00	
Car and Mine Rail account	7,534.50	
Horses and Mules	5,600.00	
Coal Sales		267,246.00
Depr. (Res.) Buildings and Machinery		12,000.00
Supplies	8,240.00	
Pay Roll, outside	24,701.50	
Pay Roll, inside	110,434.25	
Salaries, mine superintendent	6,000.00	
Salaries, office clerks	4,500.00	
Office Expense	1,147.35	
General Expense	750.00	
Claims Paid (injuries)	4,000.00	
Insurance (expires 7-1-21)	5,500.00	
Repairs to Buildings	4,075.00	
Repairs to Construction, inside	3,445.00	
Barn Expense, outside	1,500.00	
Selling Expense	4,500.00	
Royalty account	30,500.00	
Water	800.00	
Fuel	935.00	
Timber and Props	5,475.00	
Total	$459,455.35	$459,455.35

Total output of mine for year 1920....... 132,300 tons

Inventories 12–31–20:

Timber and Props	$1,500.00
Powder	555.00
Oil and Sundries	175.00

Examination of books and records shows following not entered:

Horses and Mules	$2,200.00—Dr.
Car and Mine Rail account	1,450.00—Dr.
Claim Paid (injuries)	1,000.00—Dr.

Error—$3,415.00 charged to inside construction should have been inside pay roll.

Coal is mined on a lease. Royalty 20 cents per ton.

Depreciation at rate of 5% to be considered on buildings and machinery.

REQUIRED:

Prepare Profit and Loss statement and Balance Sheet, as of this date (12–31–20), showing gross earnings, net earnings and the average cost per ton of coal. C. P. A. Ex.

Chapter Eleven

SYSTEMATIZATION (Concluded)

COST ACCOUNTING

Definition. Cost accounting may be defined as that part of general accounting which relates to the recording of manufacturing operations, such as the recording of material, labor, and manufacturing expenses—all items which enter into the cost of manufacture or construction of a definite piece of work. A cost accounting system, as ordinarily understood, is a system of factory accounts which, properly adjusted to the general system of factory operations and accounting, enables the manufacturer to ascertain with at least fair accuracy the production cost of his products and the constituent elements which make up this cost.

Need for Ascertaining True Costs. Formerly a knowledge of true manufacturing costs was not as imperative as it is today. There was a wider margin between cost and selling prices. Production did not exceed consumption. Competition was not so keen. A good profit could be realized on the investment and costs could be largely ignored. In some small concerns where costs are quite well known and in those larger concerns where the selling price is far above any possible costs, ignorance of exact costs may not involve disastrous results, even today.

However, the manufacturer who desires to obtain satisfactory results permanently or who expects to accomplish anything worth while, must quit guessing at costs in the factory. We may safely say that the point has been reached where no manufacturer will attempt to market his product without some knowledge of its cost. It is gratifying to those accountants and engineers who have for years preached the doctrine of the necessity of cost accounting as a vital feature in business to know that in the last few years business men have had a real awakening on the subject. It may now be safely assumed that every manufacturer is endeavoring to secure definite information relating to the cost of his product. In an endeavor to secure this information, practically every manufacturer has some method or system by means of which costs are figured. It does not matter how crude such a system or method may be, it represents a cost system just the same.

Place of Cost Accounting. In the early days of cost accounting systems, the cost accounts were usually kept distinct and separate from the general accounts. It was thought that the difference of standards could not be reconciled. Time and progress have shown that if best results are to be obtained, the cost system must represent an integral part of the general accounting system. It is true that a cost system kept entirely independent of the general accounting system may supply information and data of very considerable importance, but such a system fails to attain its highest usefulness and value.

A cost system should not be merely a statistical system. Materials, labor and manufacturing expenses must be accounted for accurately. By means of a sound cost system, raw material is traced to goods in process and then to finished goods. At this point the cost of production must be known before selling prices can be intelligently determined. Without information as to actual costs of production, selling prices must be determined in ignorance of the true costs. Statistics show that a very large per cent. of those concerns which fail, do so because of a lack of knowledge on the part of the management as to costs. This may be a result of no effort to arrive at costs by means of an accounting system, or it may be the result of a cost system that that does not correlate with a general accounting system; hence is nothing more than a memorandum system.

Object of Cost Accounting. (a) To Determine the Cost of Production per Unit. The fundamental object of cost accounting is the determination of production costs on each unit of product. This is the simplest and a necessary resultant of any correct and properly operated system of cost accounting. While the fundamental object is the same, there is a wide difference in cost accounting between the merchant and the manufacturer. The only elements entering into the cost of goods purchased by merchants are the purchase price, over-expenses and selling expenses. The manufacturer purchases raw material and works it into the finished product. In the process, many different machines may be used and both productive and nonproductive labor is involved. In addition, there are factory expenditures of various kinds which should be prorated over the finished product on an equitable basis. All these production costs must be known before determining selling prices.

(b) To Determine Profitable Lines of Production. It is necessary for a business man to know on which articles he is making a profit and on which he is incurring a loss. Competitive conditions are seriously disturbed where losses on one or more articles are recovered by profits on other articles. A knowledge of true costs of producing all articles will and should result in concentration of manufacture on the more profitable articles.

(c) To Secure Statistics and Reports to be Used in Determining Managerial Policies. In these days of large industrial concerns wherein personal supervision is impossible, the only reliable way by which an executive can judge of the efficiency of an organization and plans for future operations is through a system of periodic statistical reports. Such reports can only be accurately obtained when a good cost system is in operation.

Advantages of Uniform Systems of Accounts. The value derived from an adequate system of accounts is obvious. The greatest value is that of making comparisons and analyzing differences. But before any fruitful comparison can be made between figures of different periods or between figures of different

stores, it is absolutely necessary that the systems be uniform. With a uniform system of accounts in use, differences in items reflect differences in conditions, while without a uniform classification, differences in items may reflect only differences in accounting classification.

There has not been much standardization of accounts among mercantile concerns, though there has been a marked improvement towards the adoption of uniform accounting systems within different lines of trade and industry during the last ten or fifteen years. Numerous trade associations* have established uniform systems which have been put into operation by their menbers.

Cost Accounting as an Aid to Management. It has been said that "The test of industrial accounting as applied in any manufacturing plant is its utility as an aid to management." A system of factory accounts, to be of practical value, must serve as a dependable guide to the management in the administration of manufacturing operations. A proper system should furnish the necessary information for the preparation of current reports that will reveal to the management any variations between actual and standard performance which, in turn, will indicate the way to economics and increased production. Cost

*The committee on Research and Education of the National Association of Cost Accountants has compiled a list of the Trade and Manufacturing Associations which have adopted uniform accounting systems. This list follows:

Steel Barrel Manufacturers' Association.
The American Boiler Manufacturing Association.
The American Face Brick Association.
The National Association of Box Manufacturers.
Folding Box Manufacturers' National Association.
The National Association of Brass Manufacturers.
National Canners' Association.
The Casket Manufacturers' Association of America.
Portland Cement Association.
American Association of Pharmaceutical Chemists.
National Association of Finishers of Cotton Fabrics.
The National Cloak, Suit & Skirt Manufacturers' Association.
National Coal Association.
National Confectioners' Association of the United States.
National Association of Dyers and Cleaners.
Electrical Manufacturers' Council.
National Association of Electrical Contractors and Dealers.
Biscuit and Cracker Manufacturers' Association of the United States.
The Steel Founders' Society of America.
American Foundrymen's Association.
National Foundrymen's Association.
National Association of Upholstered Furniture Manufacturers.
Heating and Piping Contractors' National Association.
National Warm Air Heating and Ventilating Association.
National Association of Ice Industries.
National Implement and Vehicle Association of the United States of America.
Label Manufacturers' National Association.
National Association of Employing Lithographers.
Lime Association.
Southern Sash, Door and Millwork Manufacturers' Association.
North Carolina Pine Association.
West Coast Lumbermen's Association.
California White and Sugar Pine Manufacturing Association.
National Paint and Oil Varnish Association.
American Photo-Engravers' Association.
Writing Paper Manufacturers' Association.
Cover Paper Manufacturers' Association.
Newsprint Service Bureau.
United Typothetae of America.
Atlantic Coast Shipbuilders' Association.
Missouri Valley Association Sand and Gravel Producers.
National Association of Sheet and Tin Plate Manufacturers.
The Central Association of Stove Manufacturers.
National Association of Stove Manufacturers.
Truck Owners' Conference, Inc.
National Machine Tool Builders' Association.
The National Tent and Awning Manufacturers' Association.
American Warehousemen's Association.
Sweaters and Knitted Textile Manufacturers' Association.
International Garment Manufacturers.
Anthracite Coal Operators.
Concrete Mixers' Association.
American Hardwood Manufacturers' Association.
Allied Wall Paper Industry.
National Paper Trade Association.
Metal Finishers' Equipment Association.
Association of Chilled Car Wheel Manufacturers.

data should be so interpreted through the accounts that the factory executives are given accurate information regarding all factory activities which they wish to have presented to them, and the financial and sales executives are presented with correct statements of financial condition and operating profits and losses, as well as adequate statistics of sales, costs, and expenses of various classification.

Devising a Cost Accounting System. The devising of a cost accounting system and adapting it to a particular plant should be attempted only by one who is familiar with the operating requirements of the business and who understands the necessities of organization in industrial concerns. The factors of cost and output which have the greatest influence on ultimate profits must be discerned and practical means must be found for translating them into reports, statements and charts. A suitable type of system and construction of its details cannot be determined without an understanding of the general policies of the business.

Many cost systems have failed to accomplish the desired results because they were devised and installed without an adequate conception of the problems involved or the factors that should have been considered.

Cost Systems. While the fundamental principles of any cost system are the same, yet there are at least three distinct systems in general use. Since the object of a cost system is to allocate the costs to the products on a sound basis, the method of allocation will necessarily depend upon the conditions of production. The leading cost systems include:

(a) The Job Cost or Production Order system.

(b) The Continuous Production or Process system.

(c) The Predetermined Estimate system.

The Job Cost or Production Order System. The first step with this system is to provide a form for recording the order. The purpose of this form is to give the factory instructions as to order work which is to be done. The form should provide for the following information:

Order No.

Date.

Name and address of customer.

Distribution of work to be done, including specifications as to material needed and shipping instructions.

A job ledger is required. This should be a loose-leaf ledger. The form used should provide for information with regard to the order number, name of customer, date, cost of material consumed, labor, manufacturing expenses, this information being recorded as the order passes through the different processes of manufacture.

This system may be used with satisfactory results in any concern where goods are placed in process of manufacture in lots which can be kept separate throughout. This enables the recording of costs on each different order or lot during the process of manufacture. Each lot is given an order number and all labor and material which can be allocated directly to an order is charged to that number, an account being kept on the factory books for each number. It is usually best to provide a controlling account known as Work in Process account. Orders in process of manufacture at any time are likely to be numerous, but the manufacturing operations may be controlled on the general ledger by means of such a controlling account. Individual accounts with the various jobs may be kept in a subsidiary cost ledger if desired.

The Continuous Production or Process System. The first step with this system is to divide the entire production operations into stages or processes. The cost of each process is then apportioned over the product secured from that process, and the unit cost thus determined. The business must also be departmentalized. The departmental divisions under this system will differ from those under the Job Cost system as these divisions should be by processes, regardless of whether the work is of similar character or not. This system is much simpler than the Job Cost or Production Order system, because it is not necessary to record the costs by jobs, but by departments or processes only.

The accounts kept are practically the same except that there is not the necessity for the same detailed analysis as with the Job Cost system. Material is handled in the same manner with both systems so far as purchases and delivery to stock room is concerned. There is a difference, however, in accounting for the material as it is requisitioned out of the stock room. A material account should be opened for each department. As the material is withdrawn from stock, it should be charged to the proper department. This is true regardless of whether the material represents raw material coming from the stock room, or whether it represents the finished product of some other department. The principle is that the material account of each department must be charged at cost price with all material sent to that department. The account will be credited for the cost of material used on the completed work, the balance of the account representing the cost of the material consumed on the work in process. Accounts with Labor and Overhead Expenses should also be kept by departments.

After the goods have reached the Finished Goods account, the method of treatment is the same with both the Continuous Production or Process system and the Job Cost or Production Order system.

The Predetermined Estimate System. The first step with this system is to prepare in advance estimates as to cost of production for every article manufactured. After these estimates have been predetermined, the articles produced are valued at these estimated costs, the total value thus determined being compared with the actual expenses of operation. The degree of accuracy with which the estimates have been prepared may then be judged as a whole by the extent to which the total estimated cost of all goods manufactured during the period varies from the total actual cost of operating the factory during the same period.

This system is not to be recommended in any case where either the Job Cost or the Continuous Production systems may be used. It will be found practical, however, in many instances, owing to the great variety of articles manufactured which vary but slightly from each other, or owing to the minuteness or intricacy of the factory operations where piece-work rates are in effect and the cost of each individual operation can be very closely estimated, and it remains only to prove that no element of cost has been omitted and that the estimated cost in total is approximately correct.

Criticism of the system lies in the fact that to compare the total estimated cost of all the products with the total actual cost of operations, does not reveal definitely in what element of the costs the variations occur. This objection may be largely overcome by subdividing the operations and basing the estimated costs on these subdivisions. Corresponding operating accounts should be kept on the books for each subdivision. These subdivisions may be based upon departments. Regardless of the basis of the divisions in the estimates, the accounts must correspond.

Elements of Cost. Costs may be applied to different stages. The first is known as prime cost. The elements of prime cost are material and labor. The second is cost of production. This is represented by the prime cost plus the manufacturing expenses and represents the cost of fully manufactured goods ready for transfer from factory to sales department.

There are two more elements to be added to the cost of production in order to arrive at the selling price. The first is the selling and administrative expenses. The second is the desired per cent. of profit. Thus, it will be seen that there are four elements to be taken into consideration in determining the sales price of a manufactured article—prime cost, manufacturing expenses, administrative and selling expenses, and desired profit.

Material + Labor = Prime Cost.

Prime Cost + Manufacturing Expenses = Cost of Production.

Cost of Production + Administrative and Selling Expenses = Cost of Sales.

Cost of Sales + Desired per cent. of Profit = Selling Price.

Accounting for Material. No complex accounting principles are encountered in the handling of raw material. With a cost system, it becomes necessary to provide for a book inventory. Raw material should be stored in a stock room. The stock room should be placed in charge of a stock clerk who will keep a record of all material received by means of a material ledger, and for this purpose, cards or a loose-leaf record may be used. An account should be kept with each article. A controlling account for Raw Material will be kept on the general books. The stock clerk will be responsible for all material received. When material is purchased, it should be charged to the Raw Material controlling account in the general ledger and when placed in the stock room will be recorded on the stock records by the stock clerk. No material should be taken from the stock room except upon requisition signed by the proper persons. These requisitions are an essential part of a cost system.

A special form of requisition should be used and this should provide information regarding job numbers, departments, date, quantity, description, price, amount, and signature of foreman. The cost clerk will extend the amount on the requisition sheet and see that it is properly posted. When material is requisitioned from the stock room, it should be charged to the proper departments or to the proper job or production order numbers.

Accounting for Labor. Labor may be divided into two classes—direct or productive and indirect or nonproductive. Productive labor is that which can be charged directly to certain orders or processes. Nonproductive labor is that which cannot be charged to any particular order or process, but must be charged to the expenses of some department. The general method of recording labor is to have each employe make up a time ticket each day. This should show the employe's name, number, date and hours employed on each job, also the job number and machine number if a machine is used. In the case of nonproductive labor, the ticket should also show the department and nature of the work done in lieu of the job number. These time tickets go to the office to be recorded.

Wage System. There are many plans commonly employed in the paying of wages. A list of the more common of these plans together with a brief description of each follows:

1. Day Rate System. This plan is based on a flat rate per day regardless of the output. This plan may be considered the original wage system. Practically all other systems are a result of an effort to improve upon the day rate system because of dissatisfaction with the plan. The fact that it fails to promote efficiency, initiative, and does not offer an incentive for increased output or individual effort, are its principal objections. Generally speaking, the plan is better suited to the paying of nonproductive labor than to productive labor. No other plan is applicable to certain classes of nonproductive labor due to the

fact that the work performed is based principally upon a lapse of time as in the case of watchmen, foremen, firemen, etc.

2. **Piece Rate System.** This plan is based on a flat rate per unit of output, the rate usually being based on past experience. This plan has many advantages over the day rate plan. One of the principal advantages is that the manufacturer knows in advance the labor cost on goods to be produced. Perhaps the principal difficulty in the application of the plan is the determining of a satisfactory rate that will be fair to all concerned.

3. **Differential Rate System.** This plan is based on a rate per unit of output which increases as the output is increased. Under this plan, a standard of performance is determined. When this standard is attained and passed, the rate of pay is automatically increased. The increased rate may be applicable either to the entire production, or only to that part of production in excess of the standard set. The plan is more complicated than either of the former plans and its principal disadvantage is in the difficulty for determining the rates of payment.

4. **Premium System.** This plan is based on a flat rate per hour plus an extra allowance for time saved. The time saved equals the difference between the standardized and actual value. The fundamental principle is to reward the efficient worker in amount proportionate to the value of the time saved.

5. **The Bonus System.** This plan is based on a rate per hour which increases with an increased output. There are many variations of the plan, all of them designed to increase production by offering a reward in the form of a bonus when the standard of attainment is exceeded. The so-called Gantt system is a variation of the bonus system. The principal feature of the Gantt system is the bonus granted to the foreman for every man under him who makes his bonus.

6. **Stint System.** This plan is based on a flat rate similar to the day rate system outlined above, but with this plan the employe is given the privilege of going home when the assigned day's work is completed. A standard is set representing a day's or a week's work and when this work has been completed, the employe has earned his day's or week's wages, and the remaining time is his own.

7. **Santa Fe System.** This plan is based on a standardized output regarded as 100% efficiency, all other output representing the percentage of the standardized output. The workmen are paid on an hour or day rate plan, but are granted an additional amount depending upon their efficiency.

8. **Profit-Sharing System.** This plan is based on one of the above systems in so far as basic rates are concerned, but

in addition provides that the workman shall share in a certain percentage of the profits. The idea is that the employe will consider himself a part owner in the business when he shares in the profits, whether distributed in cash or in stock. There are many variations of profit-sharing plans.

Accounting for Overhead Expenses. Factory overhead expenses are the expenses connected with manufacturing which cannot be charged to any particular order or process. These expenses may be divided into two classes—factory departmental overhead and general overhead expenses.

Factory departmental overhead expenses cover all manufacturing expenses which can be charged directly to the various departments, such as nonproductive labor, rent, taxes, insurance, depreciation, etc. General overhead expenses includes all manufacturing expenses that cannot be charged directly to the various departments but must be distributed over the factory as a whole. There are many bases for distributing overhead expenses to the various departments. In practice, it is not practicable to distribute all overhead on one common basis, though this might be desirable from a bookkeeping point of view. All items of overhead do not vary with the same factors. For instance, rent chargeable to a department would not fluctuate with the volume of production, while power would vary with the volume of production. For each item of overhead, there must be selected a basis of distribution which under all circumstances will be the most equitable.*

Methods of Application of Overhead Expenses to Products. (a) Percentage on Direct Labor Cost. This method is based on the theory that overhead expenses are incurred in proportion to direct labor cost. It is a practical method where workers are engaged at nearly uniform wages, and where they all work under practically the same physical conditions and use substantially the same or similar equipment. Where workers are employed on a piece-work basis or where they receive practically the same wage, the method will give good results and will prove popular because of its ease of operation.

(b) Percentage on Direct Labor and Material Cost. This method is based on the theory that overhead expenses are incurred in proportion to direct labor and material cost involved. It is seldom practical or appropriate, though the method may be used where a factory's workers are employed under nearly uniform wage rates, physical conditions, and operations, and where the ratio of material cost to direct labor is approximately close to the ratio which the cost of that element of overhead expense incident to handling material is to all other elements of overhead expenses, providing the materials used are practically of the same size and kind.

*For a detailed explanation of different methods for distributing overhead expenses to departments, see pages 275-280 of "20th Century Bookkeeping and Accounting."

(c) Direct Labor Hour Rate. This method is based on the theory that overhead expenses are incurred through the lapse of time. It is a practical method where all workers are employed under practically the same physical conditions and operations. The degree of appropriateness of the system depends largely upon the degree of variation in running cost of equipment, etc., used. Where wage rates differ, this method is preferable to either of the former methods. The amount of the overhead expenses is in general more nearly proportional to the number of men employed, than to the amount of the pay roll. This method is frequently referred to as the Productive Hour Method.

(d) Machine Hour Rate. This method is based on the theory that in certain departments, the equipment used varies greatly, and that the rate of overhead expenses charged to the orders passing through the department should vary correspondingly. Under the method, a rate per hour for distribution of overhead expenses is obtained for each department. In case the machine hour rate is made to include the labor of the machine operators, no direct labor charge would be made to orders passing through that department.

Proposition A

From the following data, illustrate the methods outlined above for applying the overhead expenses of a factory to production:

	Dept. A	Dept. B	Dept. C
Material Used..........	$10,000.00	$5,000.00	$5,000.00
Productive Wages Paid..	3,200.00	2,500.00	3,500.00
Productive Labor Hours.	8,000.00	5,000.00	10,000.00
Overhead Expenses......	4,000.00	2,500.00	2,800.00

The factory is supposed to run 2,400 hours a year.

Solution

(a) To ascertain the percentage on direct labor cost, divide the overhead expenses for each department by the productive wages paid according to departments.

Dept. A	Dept. B	Dept. C
$\frac{4,000}{3,200} = 125\%$	$\frac{2,500}{2,500} = 100\%$	$\frac{2,800}{3,500} = 80\%$

(b) To ascertain the percentage on direct labor and material cost, divide the overhead expenses for each department by the sum of material used and productive wages paid.

Dept. A	Dept. B	Dept. C
$\frac{4,000}{13,200} = 30.3\%$	$\frac{2,500}{7,500} = 33\frac{1}{3}\%$	$\frac{2,800}{8,500} = 32.94\%$

(c) To ascertain the direct labor hour rate, divide indirect expenses for each department by the productive labor hours.

Dept. A	Dept. B	Dept. C
$\frac{4,000}{8,000} = 50\%$	$\frac{2,500}{5,000} = 50\%$	$\frac{2,800}{10,000} = 28\%$

(d) To ascertain the machine hour rate, divide the overhead expenses for each department by the number of hours the factory is supposed to run per year.

Dept. A	Dept. B	Dept. C
$\frac{4,000}{2,400} = 166\frac{2}{3}\%$	$\frac{2,500}{2,400} = 104\frac{1}{6}\%$	$\frac{2,800}{2,400} = 116\frac{2}{3}\%$

Proposition B

To illustrate the application of the results obtained above, under the Job Cost or Production Order system, we will assume the material and labor (value and time) chargeable to job No. 100 to be as follows:

	Dept. A	Dept. B	Dept. C	Total
Material.......	$1.00	$2.00	$1.00	$4.00
Labor Value....	1.60	1.50	1.05	4.15
Labor Hours....	4	3	3	10

Solution

The following calculations show the different total order costs obtained by each method previously explained for application of indirect expenses to production.

	Dept. A	Dept. B	Dept. C	Total
(a) Percentage on Direct Labor:				
Material.........	$1.00	$2.00	$1.00	$4.00
Labor...........	1.60	1.50	1.05	4.15
Indirect Expense..	2.00	1.50	.84	4.34
Total Cost Order No. 100......	$4.60	$5.00	$2.89	$12.49
(b) Percentage on Direct Labor and Material Cost:				
Material.........	$1.00	$2.00	$1.00	$4.00
Labor...........	1.60	1.50	1.05	4.15
Indirect Expense..	.79	1.17	.68	2.64
Total Cost Order No. 100......	$3.39	$4.67	$2.73	$10.79

(c) Direct Labor Hour Rate:				
Material	$1.00	$2.00	$1.00	$4.00
Labor	1.60	1.50	1.05	4.15
Indirect Expense	2.00	1.50	.84	4.34
Total Cost Order No. 100	$4.60	$5.00	$2.89	$12.49
(d) Machine Hour Rate:				
Material	$1.00	$2.00	$1.00	$4.00
Labor	1.60	1.50	1.05	4.15
Indirect Expense	6.65	3.12	3.50	13.27
Total Cost Order No. 100	$9.25	$6.62	$5.55	$21.42

Controlling Accounts. When the cost system is a part of the general accounting system, the principles of double entry bookkeeping are carried out by means of controlling accounts. Thus the general bookkeeper will be in a position to maintain a check on the work of the cost department. By means of the controlling accounts there will be maintained a check on the general clerical work in connection with the keeping of the cost records. The name and number of controlling accounts to be kept will vary, depending upon the cost system in use, and the nature of the business.

Controlling accounts may be kept in the general ledger with raw materials, manufactured parts, labor, factory expenses, and such other accounts as may be grouped in subsidiary ledgers. If desired, a general cost ledger may be kept in which case this would contain controlling accounts for each subsidiary cost ledger, and the only controlling account that would appear in the general ledger would be a Cost Ledger controlling account. Regardless of whether one controlling account is kept for all cost transactions, or whether separate controlling accounts are kept for the different cost elements, such as raw material, manufactured parts, labor and factory expenses, the principles are the same.

Raw Materials Account. This is a controlling account for the raw materials ledger kept by the stock clerk. The object of the account is to show the cost of materials in the stock room at the end of each cost period. The account should be charged with (a) the cost of all raw material in the stock room at the beginning of the period; (b) the cost of all material purchased and received in the stock room during the period, plus transportation charges inward. If no materials are taken from the stock room except upon requisition, these requisitions may be totaled at the end of the cost period and the sum credited to

this account and charged to the Work in Process account by means of an adjusting journal entry. Thus it will be seen that if this account is charged with the cost of all materials on hand or received during the period and credited with the total amount of material requisioned at cost price during the period, the balance of the account will represent the cost of materials in the stock room at the end of the period. This should be verified at least once a year by means of a physical inventory, and any variations should be adjusted.

Labor Account. This is a controlling account for both productive and nonproductive labor. It is charged during the period with the total pay roll. At the end of the month, the account is credited with the total labor shown on the cost clerk's labor summaries, the Work in Process account is charged with the productive labor, and the departmental expense accounts are charged with the nonproductive labor.

If the last day of the cost period does not fall on the end of a pay period, the account will not balance but will show a credit balance, this representing the amount earned by the employes but not paid. In other words, it represents the amount of accrued pay roll.

Parts Purchased Account. If, in addition to raw materials purchased, there are certain manufactured parts purchased, it may be advisable to keep a manufactured parts ledger and to keep a controlling account for manufactured parts. The principle of the account is the same as the Raw Materials account, it being charged with the cost of manufactured parts purchased and credited with the cost of parts requisitioned. The balance of the account is the amount of the manufactured parts on hand at the end of the period. This should be verified by means of a physical inventory at least once a year and any variations adjusted.

Overhead Expense Accounts. Accounts with various overhead expenses may be opened in the general ledger, or these may be grouped in a subsidiary ledger and a controlling account opened in the general ledger. The principle is the same in either case. Accounts are usually kept with each class of overhead expenditure, such as building expense, power, insurance, taxes, depreciation, etc. At the end of the month, the controlling account for overhead expenses or the individual accounts (if kept in the general ledger) are credited with the proportion of the expenses applicable to each department. The departmental expense accounts have now been charged with their proportion of the fixed charges and with the nonproductive labor. Miscellaneous expenses, supplies, and repairs will also be charged to these accounts.

During the period, these departmental expense accounts are credited with the overhead expenses distributed to the

various orders or processes. At the end of the period, the accounts are credited with the overhead expenses already distributed to work in process, and the Work in Process account is charged. After this entry has been made, the accounts theoretically should balance. There will, however, undoubtedly be small balances which will have to be adjusted. This is done usually at the end of the year when the balances are charged to Reserve for Overhead.

Work in Process Account. The purpose of this account is to show the factory cost of work in process at the end of the cost period. We have already shown that the account will be charged with:

(a) Cost of raw material requisitioned during the period.
(b) Cost of parts requisitioned during the period.
(c) Cost of productive labor during the period.
(d) The departmental overhead expenses.

The account should be credited with the cost of production of the fully manufactured output, this being transferred to the sales department. The balance of the account represents the material cost, plus labor and overhead, of work in process of manufacture, this being the factory cost of incompleted work.

Fully Manufactured Goods Account. This is a controlling account for goods fully manufactured and on hand in the sales department. The account should be charged with (a) inventory of fully manufactured goods on hand at the beginning of the period; (b) goods manufactured at cost of production during period; and (c) purchases of goods fully manufactured during period.

The account is credited with the total goods sold during the period at cost price. The balance of the account represents the inventory of fully manufactured goods on hand at the end of the period at cost of production or purchase price. This should be verified at least once a year by means of a physical inventory, and any variation should be adjusted.

A. THEORY QUESTIONS

1. State four principal objects to be obtained by a modern cost system. C. P. A. Ex.

2. What are the constituent elements to be considered in fixing the selling price of a manufactured product? C. P. A. Ex.

3. State briefly the elements of cost appearing in the following ledger accounts: (a) Raw Materials. (b) Goods in Process. (c) Finished Goods. C. P. A. Ex.

4. Give several methods of distributing indirect expenses which may be considered as standard. C. P. A. Ex.

5. What, in your opinion, is the best method of distributing the overhead or indirect expenses of a manufacturing concern so as to apportion the same to the different articles manufactured? C. P. A. Ex.

6. Define the following and give a list of expenses which would properly come under each heading:

(a) Shop overhead.
(b) General overhead. Inst Ex.

7. (a) Explain in full the theoretical difficulties in regard to each of three commonly used methods of distributing overhead burden in cost accounting.

(b) Show how the appropriateness of each system may be affected by the nature of the business in which it is employed. Inst. Ex.

8. Name and explain the various methods by which cost accounts may be handled, bringing out clearly among other items the difference between the Production Order plan and the Process plan. C. P. A. Ex.

B. ACCOUNTING PROBLEMS

1. Set up in proper form to show Manufacturing Cost, Gross Profit and Net Profit the following:

Sales; Gross Profit; Productive Labor; Productive Material; Commercial Expense; Manufacturing Expense; Nonproductive Material; Inventory Beginning of Period; Inventory End of Period; Nonproductive Labor; Net Cost of Finished Product; Inventory of Finished Product; Finished Product During Period; Selling Expenses; Gross Profit on Sales; Net Profit; Inventory of Finished Product End of Period.

Give the proper title to such a statement. C. P. A. Ex.

2. From the books of the Johnson-Koerner Manufacturing Company as of December 31, 1920, we gather data as follows:

Raw Material used	$700,000.00
Productive Labor	934,000.00
Light, Power and Heat	12,770.00
Superintendence and Indirect Labor	74,000.00
Factory Supplies	7,600.00
Repairs to Machinery and Equipment	11,400.00
Insurance on Material and Equipment	737.00
Taxes	3,370.00
Insurance on Buildings	2,058.00
Repairs to Buildings	1,376.00
Depreciation of Buildings	16,000.00
Depr. of Machinery and Equipment	24,000.00
Goods in process December 31, 1919	21,600.00

Finished goods on hand Dec. 31, 1919.....	$245,000.00
Goods in process December 31, 1920.....	45,000.00
Finished goods on hand Dec. 31, 1920.....	180,000.00

Prepare statement showing prime cost and cost of production of goods sold during year ended December 31, 1920.

Assemble this statement in such form as you believe to conform to proper accounting practice. C. P. A. Ex.

3. The Buzzer Automobile Company manufactures an assembled car. Following is a synopsis of its factory activities for a given period. Build up from the figures shown all of the relative accounts as they would appear in the factory ledger with summary of stores ledger at closing. Prepare Trial Balance from factory ledger.

Purchases including opening inventory:	
Parts Purchased......................	$ 65,000.00
Parts Manufactured (material)..........	225,000.00
Productive Labor......................	281,250.00
Factory Expense......................	451,200.00
Cost of Finished Cars:	
Parts Purchased......................	55,000.00
Parts Manufactured (material)..........	75,000.00
Productive Labor......................	188,500.00
Factory Overhead Expense.............	226,200.00
Material on hand $200,000.00.	

C. P. A. Ex.

(**Note.** It is suggested that the following accounts be opened in the factory ledger:

Raw Materials.	Factory Expense.
Parts Manufactured.	Productive Labor.
Parts Purchased.	Assembled Cars.

General Ledger.

Journalize the above data, post to the accounts opened on the factory ledger, close the accounts and bring down the balances. Prepare Trial Balance to determine if factory ledger is in balance.

The object in keeping a General Ledger account in the factory ledger is to make the factory ledger self-balancing. This is a summary account of all the factory transactions. It is just the reverse of the Factory Ledger controlling account in the general ledger. The amount appearing as a credit balance to the General Ledger account in the factory ledger appears as a debit balance to the Factory Ledger controlling account in the general ledger.)

Chapter Twelve

FEDERAL INCOME TAXES*

Income Tax Legislation in the United States. The first income tax law in the United States was enacted in 1861 during the Civil War. It was several times amended and finally expired by limitation at the end of the year 1871. Congress adopted another income tax law in 1894 as a part of the Wilson Tariff Bill, but it was held to be unconstitutional by the Supreme Court of the United States the following year in the case of Pollock vs. Farmers' Loan and Trust Company, 157 U. S. 429, on the ground that it was a direct tax and was not, in pursuance of the Constitution, apportioned among the States. In 1909 Congress enacted a third income tax law in reference to corporations worded somewhat differently from the law of 1894 and the Supreme Court upheld this law on the ground that it was an excise tax instead of a direct tax.

In order to remove any doubt as to the power of Congress to levy taxes on incomes of any nature, the Sixteenth Amendment to the Constitution was proposed and was adopted on February 25, 1913. This Amendment provides, that "Congress shall have power to levy and collect taxes on incomes from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." In pursuance of the authority granted by this Amendment, Congress enacted the Income Tax Law of October 3, 1913, which imposes a tax on the incomes of both individuals and corpora-

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*No doubt the tax on the incomes of both individuals and corporations will be a permanent part of our tax system. The present high rates will be, in all probability, somewhat modified within the next few years. The Excess Profits Tax Law may be repealed and some other form of taxation substituted. However, the indications are that for many years to come the income tax rates will be sufficiently high to be of considerable importance in their relation to the incomes of both individuals and corporations. The rates may be changed, but the general principles of the income tax law are not apt to be materially altered, consequently in this discussion, it shall be our aim to discuss the general principles of the law as well as its application, the preparation of the returns and the computation of the taxes. A knowledge of the present law is of prime importance as a basis for understanding any future law which may supersede it.

Our discussion may be subdivided into two principal parts: (1) The income tax on individuals and (2) the income tax on corporations. The discussion on income tax on individuals will be subdivided into two parts, the first relating to income to be reported and income exempt from taxation, and the second relating to deductions from gross income. The discussion on income tax on corporations will be subdivided into two parts, the first relating to taxable income, deductions from income, the filing of returns and computation of the normal income tax, and the second relating to the excess profits tax.

tions, and which superseded the law of 1909 in so far as it applies to incomes accrued subsequent to March 1, 1913. The Revenue Act of September 8, 1916, contained a new income tax law which was made retroactive to January 1, 1916, and this superseded the law of 1913. This law was, in turn, amended and supplemented by the law of October 3, 1917, effective as of January 1, 1917, which in addition to the former tax on the incomes of individuals and corporations imposed an excess profits tax on the incomes of individuals, partnerships, and corporations. The present law was approved by the President on February 24, 1919, and was retroactive to January 1, 1918. It imposes a tax at increased rates on the incomes of individuals and corporations and an excess profits tax on the incomes of corporations. It also imposes a war profits tax on the incomes of corporations for the year of 1918. It does not impose the excess profits tax on the incomes of individuals and partnerships as did the law of 1917.

It is in the law contained in the Revenue Act of 1918 that we are chiefly interested, since the previous laws are effective only as to the income accrued prior to January 1, 1918, but we shall have occasion to refer to the various regulations and decisions rendered under the prior laws since they will be of assistance in the interpretation of the present law.*

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*The basis of this discussion is the Revenue Law of 1918. The Treasury Department has from time to time issued regulations in pamphlet form dealing with the interpretation and application of the laws of 1916, 1917 and 1918. Those dealing with the Income Tax Law of 1917 are known as Treasury Regulations No. 33. Those dealing with the Excess Profits Tax Law of 1917 are known as Regulations No. 41. Those dealing with the Income and Excess Profits Taxes under the laws of 1918, applicable during 1918, 1919 and 1920, are known as Regulations No. 45.

Since we will be chiefly interested in the interpretation and application of the 1918 Revenue Law, it is suggested that you secure a copy of Regulations No. 45. In addition to these regulations, the Treasury Department has rendered various decisions with reference to questions which have arisen under the past as well as the present law. These decisions are binding as to the enforcement of the law unless overruled by the federal courts. They are, therefore, very important in the interpretation and understanding of the law. Various cases in connection with the application and enforcement of the various income tax laws have been decided by the federal courts and these decisions, of course, supersede the decisions and regulations of the Treasury Department.

The Internal Revenue Department has issued a pamphlet known as the Income Tax Primer. This consists of a series of questions and answers with regard to the more important phases of the law. A copy of the Revenue Law of 1918, Regulations No. 45, and the Income Tax Primer may be obtained from the Government Printing Office at Washington, D. C., or the Collector of Internal Revenue of your district.

In addition to the above, you should also secure from your internal revenue collector or the government printing office, copies of the forms used for making returns for individuals whose net income is not more than $5,000.00 (Form 1040A); individuals whose net income is more than $5,000.00 (Form 1040); fiduciaries (Form 1041); partnerships and personal service corporations (Form 1065); corporations (Form 1120); and such other forms as will be referred to later or may be found to be useful in the study of Federal Income Taxes.

THE INCOME TAX ON INDIVIDUALS*

Income to be Reported. The gross income received from all sources must be reported with the exception of that which is exempt as explained hereinafter. In the case of income accrued prior to March 1, 1913, it need not be reported since the Sixteenth Amendment to the Constitution, which granted Congress the right to tax incomes, did not become effective until February 25, 1913, and as a matter of convenience, March 1, 1913, is taken as the date after which income is deemed taxable.

Reporting on Cash or Accrual Basis. The individual may report his income on either a cash or accrual basis, whichever he prefers; that is, if an individual has earned income in one year which is not payable until the following year, he may include it in the return of the year when earned, or he may wait and include it in the return of the year in which it is received. For instance, an individual who is making a return upon the basis of the calendar year 1920 may have earned a salary of $300.00 for the month of December, 1920, but this may not be paid to him until sometime during the following month of January. In making his return for 1920, he may include this amount in his return for that year, or he may wait and include it in the return for the calendar year of 1921. However, he must follow a consistent policy and report all income on the same basis; that is, he cannot report part of his income on the accrual basis and part of it on the paid basis. He must also report his expenses on the same basis as his income.

Gross Income. The term "gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal,

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*The Revenue Law of 1918 provides for two taxes on the incomes of individuals. The first known as the "normal tax" is a tax which applies at the same rate to every individual regardless of the amount of his income. The second known as the "surtax" is a tax imposed on the taxable income in excess of $5,000.00, with an increase in the income. In other words, the surtax applies the principle of progressive taxation.

"Gross income" as defined in the revenue law means all income which must be reported for the purpose of taxation. "Exempt income" is that income which is not subject to the tax and which need not be reported for the purpose of taxation. "Deductions from income" include those items which can be deducted from the gross income in arriving at the net income. As indicated above, "net income" is the difference between gross income and the deductions from income. It is the amount which serves as a basis for the computation of the tax.

After the net income is determined, there are certain items which can be subtracted from it for the purpose of the normal tax but not for the purpose of the surtax. These items are known as "credits." It is important to see the distinction between a deduction from gross income and a credit; the chief distinction being that a deduction can be subtracted from gross income for the purpose of both the normal and surtax, while the credit is subtracted from the net income for the purpose of the normal tax only.

growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

Compensation of All Kinds Included. All forms of compensation for personal services are income. This includes compensations of all kinds whether received by way of salaries, fees, wages, commission, percentage of profits, or by whatever other means. Marriage fees, baptismal offerings, sums for saying masses for the dead, etc., are taxable income. Salaries of federal officers and employes are taxable under the new law. Salaries may be reported either on the accrual or cash basis; that is, they may be reported as of the year when earned or of the year when received. Compensation of an executor or trustee should be included in the return for the year when it was received although the services may have been entirely performed in other years. Where professional services are billed in one year and entered as income in the accounts, they must be reported as income in that year even though they are not collected until later.

Allowances in Addition or in Lieu of Compensation. Where living quarters, board and lodging, rent, or expenses are allowed in lieu of salary, they must be counted as income. For instance, when government employes are given quarters in addition to their salary, the estimated value of these quarters should be reported for income tax purposes. The same is true in the case of a minister who is provided a parsonage in which to live in addition to his salary. Where an expense allowance is made to a traveling man, any excess over the allowance in the expense incurred, must be reported as income.

Compensation Paid other than in Cash. If compensation for services is paid in property, such compensation will be reported to the amount of the market value of the property at the time received. If premiums are paid by an employer on life, accident, or health insurance policies for the benefit of an employe, it is income to the latter. If compensation is received in the form of notes, it should be reported to the amount of the discounted value of the notes.

Bonuses. Amounts received in the form of bonuses are income to the recipient if they are intended as a payment for services, but not if they are a gift. In some cases it is rather difficult to determine as to whether the amount is a gift or compensation for services. The Treasury Department has held that Christmas gifts are not taxable and since bonuses are frequently distributed at the end of the year, it is sometimes difficult to tell as to whether or not they are intended as a gift or otherwise. It is probably safe to assume that in most cases, where a material amount is given to the employe at the end of the year, it is intended as an additional compensation for services rendered and should be treated as an expense by the employer and as taxable income to the recipient.

Pensions and Pension Funds. Pensions received from the United States Government or from private individuals or firms are taxable income, but the pensions received from a state or political subdivision thereof are exempt. If a retired worker receives a pension from a former employer, it is taxable income since it is additional payment for prior services. Deductions from salaries or wages made by the employer to pay compulsory or voluntary contributions for pensions, or for accident, life, and health insurance should be added to the amounts received as salaries when reporting income subject to the tax.

Gratuities and Tips. Where a tip represents compensation for services, it is income for the person receiving it notwithstanding that the amount is optional with the giver. This includes tips to waiters, bell-boys, Pullman porters and others who are customarily paid for their services in this way. Gratuities not in the form of money, such as cigars, candy, or other presents are not regarded as income, but as gifts only.

Manufacturing or Trading Business. In the case of a manufacturing or trading business, gross income means the total sales less the customary deductions such as allowances, discounts, and credits given to purchasers. In addition, any special income from other sources should be added. Of course, the cost of the goods sold is subtracted from the gross sales in arriving at the gross profit on sales, but under recent regulations the cost of goods sold is treated as a deduction and, therefore, a discussion of the method of ascertaining the cost of the goods sold will be postponed until the discussion of deductions from gross income is considered.

Long-Time Contracts. In the case of long-time contracts, the taxpayer may defer the reporting of both the income and expenses in connection therewith until the completion of the contract, if he so desires. If he prefers, however, he may estimate the amount of the income earned and the amount of the expenses incurred at the end of the taxable year and make his return accordingly. If later it is found that an error has been made in the making of the estimate, it may be corrected by the filing of an amended return. To illustrate: If the taxpayer has entered into a contract continuing over a period of three years, he may not report any income or any expenses in connection with the contract until the end of the third year. Or, if he prefers, he may, at the end of the first taxable year after which he enters into such a contract, estimate the amount of income earned on the contract, also the amount of expenses incurred in earning this income and report on this basis. A good illustration of such a contract would be that of a building contractor to construct a building which it would take more than one year to complete.

Installment Sales. In the case of installment sales, if the initial payment is twenty-five per cent. or more of the sales price, the entire profit of the sale is considered as earned in the year when the sale is made. If, however, less than twenty-five per

cent. of the sales price is collected at the time of the sale, the profit may be distributed over the life of the contract and be reported for tax purposes in the year in which the payments are made. For instance, if furniture which cost $400.00 is sold on July 1 for $500.00 with an agreement that it is to be paid for in twenty equal payments of $25.00 each, it will be assumed, since there is a total profit of $100.00, that $5.00 of profit will be received at the time of each payment. If, therefore, during the current year six payments are received, it will be assumed that $30.00 of taxable income has been received. The foregoing principles govern in reference both to the sales of chattels and the sales of real estate.

Real Estate Subdivisions. Where a tract of land is purchased and divided into lots for the purpose of resale, the cost of the land should be apportioned to the individual lots. Consequently at the time of the sale of each lot the profit arising therefrom is regarded as realized for income tax purposes.

Income of Farmers. All income or profits derived from the sale of farm products is reported for tax purposes in the year when sold. The taxpayer may, however, make a return on the inventory basis if he so desires. To illustrate: A farmer who reports on a basis of the calendar year may take an inventory of all the farm products which he has on hand December 31, including those produced during the year, and report the value of these for the current year. He may, however, if he so desires, disregard the farm products produced during the year until they are sold and then report them as income for that year. If farm animals are sold, the excess of sales price over cost is taxable income. If farm products are bartered for merchandise, the market price of the merchandise should be reported as income. When shares of the crop are received as rent, this should be reported as income when reduced to cash. When stock is purchased for resale, the difference between the sales price and the cost is subject to the tax. A farmer need not include in his gross income the value of the rent of the farm house occupied by his family or farm products consumed by his family. A person operating a farm for pleasure, which involves a continual loss, is not regarded as a farmer, and is not permitted to deduct such loss from his gross income. Consequently, if such a taxpayer should, in certain years, have an income in excess of the expenses, only the excess should be reported as gross income since the expenses are not permitted as deductions.*

Sale of Real Estate. If real estate purchased since March 1, 1913 is sold, the excess of its sales price over its cost is reportable as gross income. If purchased prior to March 1, 1913, the excess of the sales price over its market value on March 1, 1913 is subject to the tax. The cost will include, in addition to the original purchase price, all expenses incurred in connection

*If the return for 1920 is made on a cash basis, a "Schedule of Farm Income and Expenses" must be prepared on Form 1040F. If the return is made on an accrual basis, the filing of this schedule is optional.

with its purchase, such as commission fees, charges for the converting of the title, and similar outlays. It also includes expenses incurred in connection with the holding of the property, such as interest charges, taxes, etc., if the property is not used for the purpose of earning an income. For instance, a real estate company may purchase a subdivision near a city and hold it five years before opening it for sale. The carrying charges during the five years may be considered as an addition to cost. The cost will also include any amounts spent for improvements on the property. If the property was purchased prior to March 1, 1913, the return must state how the market value on that date is determined. Where there is an established market value, as stocks traded in on the exchange, the quoted value is the fair value. In the case of merchandise, machinery, or other property which does not have a public market price, any relevant evidence may be considered such as the opinion of experts, prices asked, or offered for similar property at the time, or other facts. In every case this is a question of facts to be established by the taxpayer. The estimated value should not include any prospective or speculative profits, but should represent the price at which the property could have been sold under all conditions then existent.

Property Exchanged. When property is exchanged for other property with a definite or ascertainable market value, or where it is valued by parties at a fair amount for the purpose of exchange, such value must be treated as the price received for the property originally held to determine profits or losses upon the exchange, and the same amount is the cost of the new property to be used in connection with a later sale. If there is no valuation or market value, there is no closed transaction and the cost of the original property must be treated as a cost of the property acquired; in which case, when the property is sold, the original cost of the property exchanged for it will be deducted from the sales price in order to determine the profit subject to the tax.

To illustrate: J. A. Fogt owns real estate, the value of which on March 1, 1913 was $40,000.00. Arthur Williams owns real estate, the value of which on March 1, 1913, was $50,000.00. In 1920 Fogt and Williams exchanged real estate, Fogt giving Williams $20,000.00 in cash as a bonus. Fogt's deed to Williams recites a consideration of $60,000.00 cash in hand received, and Williams' deed to Fogt recites a consideration of $80,000.00 cash in hand received. In this illustration, improvements and betterments, depreciation previously claimed and the like are disregarded.

An analysis of the transaction discloses a taxable profit to both parties: Fogt receiving $20,000.00 and Williams $30,000.00 over the values of their respective properties as of March 1, 1913, which profits are calculated in the following manner:

Value of Fogt's property as of March 1, 1913, $40,000.00.
Value of Williams' property as of March 1, 1913, $50,000.00.

Fogt receives from Williams property valued at $80,000.00.

Williams receives from Fogt property valued at $60,000.00 plus a cash bonus of $20,000.00, amounting in all to $80,000.00.

The selling price of Fogt's property, $80,000.00, minus $40,000.00, representing its value as of March 1, 1913, plus the $20,000.00 bonus paid to Williams, leaves a profit to Fogt of $20,000.00 from the transaction.

The selling price of Williams' property, $80,000.00, minus $50,000.00, representing its value as of March 1, 1913, leaves a profit of $30,000.00 realized by Williams from the transaction.

The Sale of Stocks. When a number of shares of stock are held by the taxpayer which he has purchased at different times and prices, he should, if possible, at the time of sale, determine the original cost price of the stock sold. This, of course, can be done only if it is possible for him to determine when the particular share sold was purchased. If it is impossible for him to do this, it will be assumed that the first shares sold were the first shares purchased and the profit subject to the tax will be the difference between the cost and selling price thereof. If stock is received as a bonus when other stock or bonds are purchased, if possible, the cost should be allocated between the bonus stock and the stock or the bonds purchased. If it is impossible to make this allocation, no income will be reported until both the stock or bonds purchased and the stock or bonds received as a bonus are sold. At the time of sale, the difference between the total sales price and the original cost will be reported as income. When stock rights are received by stockholders, the value thereof need not be reported for taxation purposes until sold, in which case, the entire sales price is taxable.

Sale of Patents and Copyrights. When patents and copyrights are sold, the difference between the cost and the selling price constitutes income subject to the tax. If the patent or copyright was obtained prior to March 1, 1913, the profit subject to the tax is the difference between the market price of the patent or copyright on March 1, 1913 and the selling price. This is in accordance with the method of determining profit derived from the sale of any property owned prior to March 1, 1913. If in previous returns depreciation has been claimed on patents and copyrights, this depreciation must be subtracted from the original cost in determining the profit subject to tax at the time of sale. To illustrate: If a patent is purchased for $1,000.00 on January 1, 1915, and $100.00 is claimed as depreciation on the patent each year and the patent is sold on January 1, 1920 for $800.00, the profit subject to the tax is the difference between $500.00, the book value of the patent and the selling price.

Sale of Good Will. Good will is not considered in determining income subject to tax unless it is sold, in which case, the difference between its cost and selling price constitutes income subject to the tax. Since good will is not considered subject to depreciation or appreciation in determining income subject to

tax, the profit at the time of sale is always the difference between its original cost and the selling price.

Rents. Income from rents may be reported like other income, on either a cash or accrual basis. Income from this source must be reported whether it is paid in cash or other property. Farmers, for instance, may receive a part of the crops produced on the land as rent and this must be reported as income, although they are permitted to defer reporting it until it is reduced to cash, if they so desire.

If tenants construct buildings or improvements upon leased property, the title to which goes to the owner of the property at the termination of the lease, the value of such improvements must be reported as income by the owner. Interest and taxes paid by a tenant on behalf of the landlord are income for the landlord when paid and also may be deducted by the landlord as payment by him. Ordinarily, repairs made by the tenant are not income by the landlord, but expenses by the tenant. The value of the use of property by the owner need not be counted as income by the owner nor may it be deducted as rent paid.

Interest. Interest on obligations of every kind accrued since March 1, 1913, except that as stated exempt under "exempt income," is taxable. Such interest must be reported when it becomes subject to the demands of the owner whether or not it is reduced to his possession. For instance, interest on bank deposits must be reported as income when they are credited to the account of the depositor although he may not withdraw them at that time. Interest accrued on bonds prior to their purchase need not be reported by the purchaser. For instance, if a bond bearing six per cent. interest and with a par value of $100.00 is purchased for $103.00, and six months later the purchaser collects $6.00 in interest, he need report only $3.00 as income, the remaining $3.00 being considered as a return of part of the purchase price.

Bond Premium and Discount. When bonds are purchased at a premium or discount, this premium or discount need not be reported in entirety in the year when purchased, but may be amortized over the life of the bond. If a city purchases a public utility and assumes the bonds, the interest on such bonds is subject to the tax. If the city had issued the bonds originally, the interest would be exempt, but since the purchaser of the bonds at the time of their purchase anticipated a payment of the tax, its payment is not waived because the city later assumes the payment of the bonds. Similarly, the income from corporations, which are themselves exempt, is not necessarily exempt to the recipient.

Income from Fiduciaries. Income received from fiduciaries may or may not be exempt, depending on its source. In other words, it is necessary to determine from what source the fiduciary received the income before determining whether or not

it is taxable in the hands of the one who receives it from the fiduciary.

Partnership Income. A partnership, unlike a corporation, has no legal existence aside from the members who compose it, and, therefore, the income which it receives belongs immediately to the partners with no declaration of dividend, just as if it was received directly by them. The income of the partnership for the calendar year or fiscal year must be shown on a partnership return and the amount belonging to each partner indicated on the return.*

Individuals carrying on business in partnership are liable for income tax only in their individual capacity. There must be included in computing the net income of each partner his distributive share of the net income of the partnership for the taxable year, whether distributed or not, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed. The net income of the partnership shall be computed in the same manner and on the same basis as that of an individual except that the deduction for charitable contributions is not allowed.

Any citizen or resident, who is a member of a partnership, shall be credited with his proportionate share of any income, war profits or excess profits taxes of the partnership paid during the taxable year to a foreign country or to any possession of the United States as the case may be.

The term "individual beneficiary" may include a partnership beneficiary. Accordingly, a partnership is not required to include in gross income the proceeds of life insurance policies paid to it upon the death of the insured. Every partnership must make a return showing the gross income, the deductions allowed by law and the net income; also the distributive interest of each partner in the partnership profits, whether such profits have been distributed or not, with the names and addresses of the persons who would be entitled to such profits if distributed. The return may be sworn to by any one partner.

Partnership Contributions. The partnership itself shall not be subject to either the excess profits or the income tax. In computing the net income of the partnership, no deductions shall be made for contributions or gifts made by the partnership. The partners shall take credit in their individual returns of their proportionate share of any such contributions or gifts so made by the partnership, not to exceed 15 per cent. of the individual's net income.

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*Form 1065 should be used in reporting the income for partnerships for the year 1920. No tax is assessable on this return. Shares or net profit or loss should be reported on "Individual Returns," Form 1040 or 1040A.

Dividends. Dividends received from domestic corporations and the dividends received from a foreign corporation, whose entire income is from United States sources, are subject to the tax. The Revenue Law of 1918 defines a "dividend" as follows: "That the term 'dividend,' when used in this title, except in paragraph ten, subdivision A, Sec. 234, means (1) any distribution made by any corporation other than a personal service corporation to its shareholders or members, whether in cash or other property, or in stock of the corporation out of its earnings or profits accumulated since February 28, 1913, or, (2) any such distribution made by a personal service corporation, out of its earnings or profits accumulated since February 28, 1913, and prior to January 1, 1918."

Miscellaneous Types of Dividends. Dividends received from private banks organized as corporations are subject to the tax. Dividends from paid-up insurance policies are treated the same as other dividends from corporations. Taxes paid by a bank on its stock for the owners of the stock are considered as a dividend to the owners. Dividends paid from surplus created by the appreciation of assets are not considered as taxable.

How Taxed. Dividends received by an individual from a corporation, the income of which is subject to the corporation income tax, are subject to the surtax, but are not subject to the normal tax. However, they must be included in gross income and then taken as a credit in determining the amount subject to the normal tax.

Stock Dividends. In the case of Towne vs. Eisner, it was held by the U. S. Supreme Court that stock dividends were not taxed under the Revenue Act of 1913, which did not expressly refer to them, and Macomber vs. Eisner recently decided by the Supreme Court, held that they are not taxable under the Revenue Act of 1916, although it expressly so provided. The provision in the Revenue Act of 1918 is, in effect, the same as in the Revenue Act of 1916 and specifically taxes stock dividends. In accordance with the later decision, stock dividends are not subject to taxation and, accordingly, taxes paid upon any stock dividends will be refunded upon the submission of proper claims.

Sources of Dividend as to Year. Under the new law, dividends are presumed to be from profits so long as any profits exist. In other words, a corporation cannot declare a dividend and specify that it is a liquidating dividend and thereby exempt from the income tax so long as there are any profits from which dividends might be declared. It is also presumed that any dividend declared is from profits earned since February 28, 1913, until all such profits have been distributed. As may readily be surmised, the purpose of this is to prevent the declaration of dividends by corporations which had a surplus accumulated prior to February 28, 1913, and making them exempt from the tax by stating that these dividends are from profits earned

prior to the passing of the Sixteenth Amendment. Under the new law, the dividends are taxable at the rate of tax of the year when paid regardless of the year in which the profits were earned.

Liquidating Dividend. As stated previously, a dividend can be considered as a liquidating dividend only when all profits of the corporation have been distributed. When liquidating dividends are made, if they are in amount greater than the original cost of the interest of the stockholder in the corporation, this excess is considered as a profit subject to the tax. To illustrate: If Brown buys 10 shares of stock for $1,000.00 in the X corporation, and later this corporation dissolves and pays Brown $1,200.00 for his interest, the $200.00 excess is taxable.

Dividend from Depletion Reserve. In a case of a corporation which has a depletion reserve, a dividend can be paid and charged to this reserve only when the surplus and other reserves of the corporation have been exhausted. Such a dividend, when paid, is not considered subject to the tax unless it is in excess of the cost of the stock which the recipient holds in the company.

Special Source of Income. Income may be received from many different sources, and in the main, income received from any source whatever, except those stated under exempt income, is subject to the tax.

Royalties from mines, patents, franchises, etc., are income subject to the tax; also any profit derived from the sale of royalties, patents, and copyrights. If a debt is charged off as bad and is later collected, it must be reported as income in the year when collected. Where property is lost by shipwreck, fire, or other casualty, or taken by right of eminent domain and more is received in compensation therefor than the property cost, the excess must be reported as income. In case property is taken over by the government for any purpose and the amount paid by the government for the property is greater than the cost of replacement, the excess must be reported as income. If, however, it is desirable for any good reason that the replacement of the property is postponed, a replacement fund may be created temporarily and no income reported until the property is later replaced.

If an individual is released from a debt which he owes to another in return for services performed by the debtor, it is regarded as income for the latter. If, however, the release is granted merely as a benefit to the debtor, it is regarded as a gift and not income subject to the tax. If a stockholder releases a corporation from a debt due from it to him, it is regarded as a capital contribution to the corporation and, therefore, is not subject to tax in the hands of the corporation and cannot be treated as a deduction by the stockholder. If a corporation releases a stockholder from a debt due by him to it, it is regarded as a dividend and must be reported by the stockholder as such.

Income Exempt from Taxation

Life Insurance. Proceeds of life insurance policies paid to an individual as beneficiary or to the estate of the deceased upon the death of the insured need not be reported for taxation. Any amount received by the insured as a return of premiums paid by him on life insurance, endowment, or annuity contracts, either during the term of insurance, at maturity, or upon the surrender of the policy can be subtracted from the proceeds of the policy in arriving at the amount subject to taxation. To illustrate: If an individual receives $5,000.00 at the maturity of an endowment policy and he has paid $4,000.00 in premiums on this policy, he would report for taxation only the difference between the premiums paid and the amount received, or $1,000.00.

Property Acquired by Gift, Bequest or Descent. The value of property acquired by gift, or descent, is not subject to the income tax, but any income derived from such property is taxable. If the property is sold or disposed of, any profit derived from its sale is taxable as income. If the property was acquired prior to March 1, 1913, the profit is the difference between its market value on that date and the sales price. If acquired since March 1, 1913, the profit is the difference between the cost price and the sales price, making suitable allowance for depreciation. To illustrate: If property is sold for $20,000.00 in January, 1919, which was purchased in 1910, it would be necessary to estimate the market value of such property on March 1, 1913, in order to arrive at the profit which is subject to the tax.* If it is assumed that the property cost $10,000.00 in 1910, but had a market value of $15,000.00 on March 1, 1913, the profit which is subject to the income tax would be $5,000.00. On the other hand, if property purchased on January 1, 1915, for $5,000.00 is sold in 1919 for $6,000.00 and during the years 1915, 1916, 1917 and 1918, $250.00 a year or $1,000.00 total had been claimed as a deduction from income because of depreciation on this property, the profit arising from this sale subject to the income tax would be $2,000.00.

Income from State and Municipal Offices. Gross income does not include interest on bonds or other obligations of a state or political subdivisions of a state. The term "political subdivision" includes any special assessment district or division created by the proper authority of a state acting within its constitutional powers for the purpose of carrying out some public work. This includes drainage districts, school districts, highway districts, etc.

Interest on Obligations of the United States. The law exempts interest on the obligations of the United States issued before September 1, 1917, and on those issued after that date, if and to the extent, provided in the act authorizing their

*Only the profit accruing since March 1, 1913, is subject to tax because the Sixteenth Amendment did not become effective until February 25, 1913, and for convenience March 1, 1913, is fixed by law as the date of computation.

issue. United States bonds of the first Liberty Loan and all prior issues are wholly tax exempt. All subsequent issues of liberty bonds are wholly exempt as to the normal tax on income of individuals. In addition, the income on an amount not exceeding $5,000.00 held by any individual, partnership, association, or corporation is exempt from the surtax, income tax on corporations, and the excess profits tax. There are also additional provisions by which larger amounts may be held exempt from all tax if they are properly distributed among the various issues. Reference should be made to the detail regulations which are given in Treasury Regulations No. 45 in order to determine as to whether the income from liberty bonds is exempt in filing returns for individuals whose income is in excess of $5,000.00, and who hold over $5,000.00, of these obligations of the United States. The Schedule of Taxable Interest on Liberty Bonds should be prepared on Form 1125. See page 191.

Health and Accident Insurance. The new law prescribes that amounts received through accident or health insurance, or under workmen's compensation acts as compensation for personal injury or sickness, are exempt. The same is true with reference to the amount of any damages received whether by suit or agreement on account of such injuries or sickness.

Salaries of U. S. Soldiers and Sailors. Gross income does not include so much of the salary and compensation received during the present war for active service in the military or naval forces of the United States as does not exceed $3,500.00. Compensation of persons in the Army and Navy in excess of $3,500.00 is subject to tax as also is income received by such persons from sources other than from the Government. To illustrate: Captain John Brown may receive $2,400.00 salary during the year 1919. In addition he may have an income of $4,000.00 from property owned. The $2,400.00 is exempt, but the $4,000.00 must be reported.

Salaries of State and Municipal Employes. Salaries of all officers and employes, whether elected or appointed, of any state or territory or any political subdivision thereof, are held to be exempt under the new law. Although the law does not specifically mention the income of such classes as being exempt, the Commissioner of Internal Revenue has so ruled, and their income need not be reported in so far as it may be derived from such sources. This includes the salaries of all municipal employes and all teachers receiving their salaries from public funds. It does not exempt the salaries of teachers in private schools. The income of such employes received from other sources is, of course, subject to the tax.

Alimony. Any amount received as alimony or as an allowance under a decree of court or separation agreement, need not be included in gross income of the recipient, nor may it be deducted by the person who pays it.

Federal Farm Loan Act Securities. The Federal Farm Loan Act as well as the income tax law provides that the securities issued under the former act shall be exempt from income taxation. The same is true of dividends received from Federal

Form 1125.—UNITED STATES INTERNAL REVENUE SERVICE

SCHEDULE OF TAXABLE INTEREST ON LIBERTY BONDS

(To be filed with the Collector of Internal Revenue with Form 1120 and Form 1122)

For Calendar Year 1920

Or for period begun.................., 19...., and ended............................., 19....

Name of Corporation..

Address...

1. Obligations.	2. First 4's, and Second 4's.		3. First 4¼'s, Second 4¼'s, and Third 4¼'s.		4. First Second 4¼'s.		5. Fourth 4¼'s.		6. ....% Other Obligations issued since Sept. 1, 1917.		7. Victory 4¾'s.		8. War Finance Corporation 5% Bonds	
(a) Amount of interest....	$..........	....	$..........	....	$..........	....	$..........	....	$..........	....	$..........	....	$..........	....
(b) Average principal...	....	....	....	....	....	....	....	....	....	....	....	....	....	....
EXEMPTIONS: (c) $5,000.....	....	....	....	....	....	....	....	....	....	....	x x x x x x x	x x	x x x x x	x x
(d) $20,000.....	....	....	....	....	....	....	....	....	x x x x x x x	x x	x x x x x x x	x x	x x x x x	x x
(e) $30,000.....	....	....	....	....	....	....	....	....	x x x x x x x	x x	x x x x x x x	x x	x x x x x	x x
(f) $45,000.....	....	....	....	....	x x x x x	x x	x x x x x x x	x x	x x x x x x x	x x	x x x x x x x	x x	x x x x x	x x
(g) $30,000.....	x x x x x	x x	x x x x x x x	x x	....	....	x x x x x x x	x x	x x x x x x x	x x	x x x x x x x	x x	x x x x x	x x
(h) $30,000.....	x x x x x	x x	x x x x x x x	x x	x x x x x	x x	....	....	x x x x x x x	x x	x x x x x x x	x x	x x x x x	x x
(i) $5,000.....	x x x x x	x x	x x x x x x x	x x	x x x x x	x x	x x x x x x x	x x	x x x x x x x	x x	x x x x x x x	x x	....	....
(j) Principal in excess of exemptions..	....	....	....	....	....	....	....	....	....	....	....	....	....	....
(k) Taxable interest....	$..........	....	$..........	....	$..........	....	$..........	....	$..........	....	$..........	....	$..........	....

(l) Total taxable interest as computed on line (k) above (enter on Form 1120, page 1, in Schedule A, as Item 4)........................ $..................

(For instructions for filling in table above, obtain copy of Form 1125 from office of Internal Revenue Collector. Space does not permit inclusion of these instructions here.)

Reserve Bank Stock. This exemption applies only to dividends on stock of Federal Reserve Banks, and not to dividends on stock of member banks.

Bonds of the War Finance Corporation. Interest on bonds issued by the War Finance Corporation is exempt, if and to the extent, provided in the respective acts authorizing the issue thereof.

Nonresident Aliens. In the case of nonresident aliens only the income received from sources within the United States is taxable. In the case of resident aliens, however, all income from whatever source derived is taxable by this Government. A nonresident alien is an alien living elsewhere than the United States or an alien living temporarily in the United States. If the alien manifests his intention to remain here permanently, he becomes a resident alien and is taxed the same as a citizen.

INCOME TAX QUESTIONS AND PROBLEMS

1. Is the income of interest on liberty bond issues taxable under the present revenue law? If so, to what extent?
Inst. Ex.

2. (a) Under the federal income tax laws, how are the profits determined in an exchange of real estate for stock of a corporation? In the sale of stocks or bonds or other property? In the exchange of one stock for another stock?

(b) A purchased a plot of vacant land in 1903 for $5,000.00. In 1920, he sold it still vacant for $7,500.00. How should this transaction be treated by A in preparing his income tax return?
Inst. Ex.

3. A during 1920 sells B for $50,000.00 certain property which A purchased in 1914 for $30,000.00 and B agrees to pay A, in addition to the purchase price, the income taxes which A may be required to pay on the profit of $20,000.00.

Does the payment of such taxes to A amount to income to A which he will be required to report as taxable income?
C. P. A. Ex.

4. A, being the owner of 100 shares of the capital stock of the X company, which he purchased in 1914 for $10,000.00, in 1920 exchanged them for a plot of real estate in the city of New York. Is this transaction to be considered for income tax purposes, and if so, what further data would you need to determine whether or not it would affect the income tax return of the individual in question, and why? Inst. Ex.

5. A man purchased in the year 1912, 100 shares of stock in a local manufacturing corporation at cost of $100.00 per share. On March 1, 1913, the market value of the stock amounted to $150.00 per share. In the year 1917, its market value amounted to $500.00 per share and he donated the stock to his wife. In the year 1920, there had been no change in market value and the wife sold the stock for $500.00 per share, which constituted all her income.

What was the income tax of the wife? C. P. A. Ex.

Chapter Thirteen

FEDERAL INCOME TAXES

THE INCOME TAX ON INDIVIDUALS (Continued)

Deductions from Gross Income. After the gross income has been determined, certain deductions from gross income are allowed in computing net income. The income tax is on the net income and not the gross income. The net income is determined by subtracting the allowable deductions from the gross income. Under the law, the following items are considered allowable deductions from gross income:

1. Business expenses.
2. Taxes.
3. Interest.
4. Losses.
5. Bad debts.
6. Depreciation.
7. Amortization.
8. Depletion.
9. Charitable contributions.

General Business Expenses. For the purpose of the income tax it is very necessary to make a clear distinction between business expenses and personal expenses. Business expenses are expenses incurred in connection with carrying on a business by an individual and are deductible in determining the income subject to the tax. Personal expenses are the personal expenses of the individual or his family and are not deductible in determining net income.

In reporting his business expenses the individual may report them on either the cash or accrual basis. However, his expenses must be reported on the same basis as his income. If he elects to report his income on the cash basis he must report his expenses accordingly and vice versa.

Expenses incurred in earning exempt income are not deductible. For instance, expenses incurred in connection with the purchase of municipal bonds or the collection of interest on municipal bonds would not be deductible since the interest from the bonds is exempt from taxation.

The cost of repairs incurred in the maintenance of property or equipment used in carrying on the business is deductible, but the cost of repairs in connection with the home in which the individual lives or the equipment in the home or of property, such as automobiles used for private purposes, is not deductible.

An individual engaged in the rendering of professional services, such as a physician or lawyer, may deduct the cost of all supplies necessary for the carrying on of his professional work and of all expenses incurred in the operations thereof.

Compensation for personal services may be deducted if paid to others than the taxpayer himself or to a minor child of the taxpayer. In case of a corporation, compensation paid to the taxpayer himself may, of course, be deducted. In the case of a business organized other than as a corporation, the claiming as a deduction of compensation paid to the taxpayer would serve no purpose, since if he claimed it as an expense of the business he would have to report it as an income to himself and the net result would be the same.

Bonuses paid to employes as compensation for services may be treated as a deduction. If, however, the bonus is made merely as a gift to the employe, it is not regarded as an expense and may not be treated as a deduction. No doubt, bonuses are always given in return for services rendered; therefore, they should always be deducted.

Compensations paid to individuals for injuries received in the business or to dependents of such individuals are deductible. Contributions to pension funds which are held by the business for the benefit of employes are not deductible.

Payments for rent may be deducted regardless of the form in which paid. Where a leasehold is purchased, the cost of the leasehold should be allocated over its life and not claimed as a deduction of the year purchased. Taxes paid by the tenant for the landlord are regarded as additional rent. The cost of erecting buildings on leased property which are to go to the landlord at the termination of the lease may be allocated over the life of the lease.

A farmer may deduct all expenses incurred in connection with the production and disposition of all products produced on the farm. This includes the cost of labor used in connection with the production of crops or live stock, the cost of seed, fertilizer, and the original cost plus the cost of feed of stock purchased for resale. Repairs to farm buildings, fences, and farm machinery may be treated as an expense, but repairs on the family dwelling may not be so treated. Reasonable depreciation on all property and equipment other than the family dwelling may be treated as a deduction.

Miscellaneous Business Expenses. It has been previously stated that it is impossible to give all the miscellaneous sources of income which is subject to the tax. In the same manner it is impossible to name all the individual items of business expense which may be deducted. For purposes of illustration, however, a number of miscellaneous items will be mentioned.

The expenses of advertising may be deducted by a merchant. Wages, heat, light, water, telephone, and entertainment of out-of-town guests may also be deducted by a merchant. A taxpayer cannot deduct wages paid to his minor child. This is based on the theory that he is entitled to the services of such child without compensation and any compensation paid is merely a gift or gratuity to the child. As a general rule, the cost of clothing cannot be deducted, but actors may deduct the cost of clothing used for stage purposes only. The wages of personal servants cannot be deducted, since these are regarded as personal expenses. The cost of maintaining an auto for personal use cannot be deducted, but if the auto is used for business purposes, such expenses can be deducted. Car fare incurred in traveling to and from one's place of business is regarded as a personal expense and cannot be deducted. Dues paid to social clubs cannot be deducted, but dues of commercial or professional clubs may be deducted as an expense. The cost of technical magazines relating to the taxpayer's profession may be deducted, but the cost of literary magazines cannot be deducted.

Depreciation may be claimed on books purchased for the taxpayer's library. Premiums paid on a fidelity bond is considered as a business expense. Expenses incurred on business trips are deductible, but the cost of lodging is not. Insurance on business property may be deducted, but insurance paid on the home in which the taxpayer lives is not deductible. The premiums on life insurance or personal insurance of any kind is not deductible. Lobbying expenses and campaign contributions are not regarded as deductible expenses.

Distinction between Business Expense and Capital Outlay. It is sometimes quite difficult to determine when an expenditure should be considered as an expense and when it should be considered as a capital investment. A few illustrations will be given to serve as a guide. The expenses incurred in the organization of a corporation cannot be treated as an expense, but are considered as capital expenditures. Assessments on capital stock are not regarded as an expense to the stockholder, but as an additional investment. Expenses such as insurance, the benefit of which may be derived for a period of years, should not be treated as an expense at the time of its occurrence, but should be spread over the period which is to be benefited. Maintenance expense and repairs are deductible, but betterments to property are not. The defending and protecting of title is considered as a capital charge and not as a business expense. Architect fees in connection with the construction of a building is considered as part of its cost and not as an expense. The cost of copyrights and patents are not deductible, although depreciation may be claimed in connection therewith. The cost of carrying property which is not being used in the conduct of the business is regarded as a capital charge and not as an expense.

Interest. The Revenue Law of 1918 says "All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred to purchase securities, the income upon which is exempt, may be deducted." It will be noticed that the law says "all" interest, therefore, interest on both personal and business indebtedness may be deducted. This seems rather illogical, but nevertheless it is permissible under the law. At one time the Commissioner of Internal Revenue ruled that the law referred only to interest paid on the indebtedness of the taxpayer incurred in the conduct of his business. This decision, however, was later overruled and at the present time interest on both personal indebtedness and business indebtedness can be deducted. It will be noticed that interest on indebtedness incurred to purchase securities, the income of which is exempt, is not deductible.

As a consequence, interest on funds borrowed to purchase obligations of the United States, issued prior to September 24, 1917, is not deductible, but interest on money borrowed to purchase United States bonds issued since the above date is deductible, since the interest on such obligations is only partially and not entirely exempt. Interest on money borrowed to purchase municipal or state bonds is not deductible. Interest on capital of the taxpayer invested in the business is not deductible. Interest, like other expenses, may be reported on either the cash or accrual basis, but, of course, the method employed must be the same for all expenses. A nonresident alien can deduct only the interest paid on indebtedness which has been incurred in order to earn income which is taxable in the United States.

Taxes. Individuals may deduct all taxes paid or accrued except income and excess profit taxes levied by the United States and assessments levied for local benefits. Examples of the latter kind are assessments paid by the property owner for the paving or extension of streets in a city, or by the landowner for irrigation or drainage in agricultural districts. These assessments are not regarded as a deductible expense because they are supposed to increase the value of the property to the extent imposed. Although excess profit taxes cannot be treated as a deduction, they may be treated as a credit in arriving at the amount of the net income subject to the income tax. Under the new law, an individual is not subject to the excess profits tax, so this item would not be considered in connection with any income accruing since January 1, 1918.

Inheritance taxes are not deductible, for they are charged against the corpus or body of the estate and not against its income. Taxes paid on property used as a home may be treated as a deduction. It will be noticed that though insurance on a home or rent paid for a home are not deductible, that the taxes paid on a home or interest paid on indebtedness incurred in order to purchase a home are deductible. Although this seems somewhat inconsistent, it has been the holding of the Treasury

Department since the passage of the first income tax law, therefore, there is little chance of its being changed. In case of custom duties, such as duties imposed by the tariff, they are deductible if paid on goods for resale by a business, but are not deductible if incurred upon personal property.

The deductible taxes include the taxes on railroad tickets, theatre tickets, soda water and toilet articles, but the inconvenience of keeping a record of such taxes paid is probably sufficient to deter most people from taking advantage of the right to deduct them.

Business Losses. The law provides that not only losses incurred in the trade or business, but also all losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with trade or business, may be treated as a deduction. Likewise, losses sustained during the taxable year of property not connected with the trade or business arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise, are deductible.

If personal property such as jewelry, automobiles, etc., are stolen or destroyed by fire or other elements, their value may be deducted. Thefts of merchandise are not treated as a deduction since the loss thus incurred will be taken care of when the inventory is taken. If a loss is covered by insurance, the amount of the insurance received will be reported as income. In cases of losses incurred through accidents, they are deductible if incurred in the scope of the business, otherwise not.

It has been held that where an old building is removed in order that it may be replaced by a new one, the cost of removal is a capital charge and cannot be treated as an expense. Likewise, in case of loss by destruction of buildings pursuant to orders of government authority because of their unsafe or unsanitary condition, no deduction is permitted.

To illustrate a deductible loss, assume that a man buys half of the stock of a corporation whose business is to operate a moving picture show. The assets of the corporation consist of a lease for two years of premises in which the moving picture show is operated. He pays $900.00 for the half interest. The earnings average $100.00 per month for two years, a total of $2,400.00. The stock then becomes worthless. In making a return of income, A may deduct $900.00 paid for the stock as a loss. The stock is regarded as a loss, but if A had received bonds instead of stock, the $900.00 deduction would have been as a bad debt.

In further illustration, assume that A is regularly engaged in the business of buying oil leases and in the producing and marketing of oil. During the year 1920, he suffered business losses to the amount of $5,000.00, due to the drilling of dry holes, etc. During the same year, he received from oil corporations

as dividends the sum of $10,000.00. The losses sustained, due to the drilling of dry holes, may be deducted from the amount received as dividends. In this case, the deduction serves to reduce the surtax, dividends not being subject to any normal tax.

Bad Debts. The law provides that "debts due to a taxpayer and actually ascertained to be worthless and charged off during the year may be deducted." There has been much criticism of this provision of the law since it does not permit a deduction for anticipated losses on bad debts. From the viewpoint of good accounting, it is desirable that the estimated loss on account of bad debts, based on the experience of past years, be placed on the books at the end of each fiscal period. The law will not permit, however, that the amount thus estimated be treated as a deduction. The debt cannot be deducted until it is actually ascertained to be worthless and charged off the books.

There has been some confusion as to when it is ascertained to be worthless. The Treasury Department has ruled that in order to comply with this provision it must be ascertained without reasonable doubt that it is bad; however, the Department has held that in the case of a bankrupt corporation which has some assets, debts which it may owe cannot be regarded as ascertained to be worthless until the trustee in bankruptcy has wound up the estate and has been discharged by the court. In the case of a debt which has arisen from income due, it cannot be treated as a deduction when ascertained to be bad unless the income which it represents was reported at the time it accrued. For instance, if interest is due on money loaned and later it is found that the amount of the interest is uncollectible, it cannot be treated as a deduction unless it has been previously reported as income. In case of a dispute as to the amount due, if a compromise is made and a less amount is accepted in payment than was first claimed, the difference cannot be treated as a deduction; however, if there is no dispute as to the amount of the debt, and if the smaller amount is accepted in order to obtain immediate payment, the difference may be treated as a deduction.

If the endorser of a note has to pay it on the default of the payor its amount may be treated as a deduction. In case of a foreclosure of a mortgage held by a taxpayer, the difference between the amount received as a result of the foreclosure and the amount due on the mortgage may be treated as a deduction, if the property is not purchased by the mortgagee. In the latter case, no deduction can be made until the property is finally disposed of and the loss incurred actually ascertained.

Depreciation, Obsolescence and Amortization. The law provides that a reasonable allowance for exhaustion, wear or tear of property arising out of its employment in business or trade may be treated as a deduction. No depreciation is allowed, however, upon the property used as a residence either

in city or country. When the full value of the property has been deducted by means of depreciation, no further allowance is permitted. For instance, if the taxpayer estimates that an asset which cost $800.00 will last for ten years and claims as a deduction $80.00 each year., but finds that at the end of the ten years the asset has still a value of $200.00, he is not permitted to claim any further deduction after the tenth year.

No allowance for depreciation is permissible upon items of personal property. For instance, depreciation cannot be claimed upon an automobile used only for personal purposes. Neither depreciation nor appreciation of land is considered. In case of renewals or replacements which do not appreciably lengthen the life of the property and which are charged against depreciation reserves, no deduction can be claimed. In order that depreciation may be claimed as a deduction, it must be entered upon the books. It was formerly held it must be credited to the asset to which it related, but later rulings permit it to be expressed in a reserve account. The latter method is, of course, the one approved by good accounting practice and should be followed in every case.

At one time the Treasury Department held that the amount of the depreciation reserve must be set aside as a special fund and could not be used in the conduct of the business, but this has also been reversed and now the amount of the depreciation reserve can be represented by the general assets of the business and need not be shown separately. This is, of course, in accord with sound accounting practice. No depreciation on good will is permissible. The law of 1918 provides that a reasonable allowance for obsolescence may be considered in the calculation of depreciation.

In the case of buildings, machinery, equipment acquired, or vessels constructed or acquired on or after April 6. 1917, for the purpose of contributing to the prosecution of the present war, there is allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer.

At any time within three years after the termination of the war with Germany, the Commissioner of Internal Revenue may, at the request of the taxpayer, make a re-examination of the taxpayer's returns in order to determine if proper allowance has been made for this item of amortization; and if upon re-examination, it is found that the original deduction allowed was incorrect, the amount of taxes for the years affected will be redetermined and any tax which may be found to have been overpaid will be refunded or credited to the taxpayers.

Depletion. The distinction between depreciation and depletion should be clearly understood. Depreciation is a decrease in the value of assets due to their use in the business, while depletion refers to the decrease in the value of the asset because it enters into the making of the commodity sold. For instance, depreciation occurs in connection with the machinery used in a coal mine, but depletion occurs in connection with the mine itself because the coal is actually being removed and sold.

In the case of mines, oil and gas wells, other natural deposits and timber, a reasonable allowance for depletion and depreciation of improvements will be allowed according to the peculiar conditions in each case, based upon cost, including cost of development not otherwise deducted, and in case of property acquired prior to March 1, 1913, the fair market value on that date may be taken in lieu of cost.

In the case of the above properties (except timber) discovered by the taxpayer on or after March 1, 1913, where the fair market value of the property is materially disproportionate to the cost, depletion allowance may be based upon the fair market value of the property at the time of discovery or within 30 days thereafter. In the case of leases, the deductions for depreciation and depletion allowed shall be equitably apportioned between the lessor and lessee.

Contributions or Gifts. Contributions made to corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any stockholder or individual, or contributions to the special fund for vocational rehabilitation authorized by Section 7 of the Vocational Rehabilitation Act, may be deducted,* providing they do not exceed fifteen per cent. of the net income of the individual. This deduction is allowable only to individuals and not to partnerships or corporations. In the case of a nonresident alien, a deduction is permissible only in case the contribution has been made to a domestic corporation.

Items Not Deductible. In arriving at net income for the purposes of the tax, the following items must not be deducted from gross income:

(1) Personal living or family expenses, such as cost of maintaining a home, servants' wages, family life insurance premiums, allowances made as gifts to dependents, cost of purchase and upkeep of pleasure automobiles, chauffeurs' hire, railroad commutation fares to and from place of business and similar items.

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*Such contributions or gifts have been construed to mean gifts of money or property. The value of services rendered to charitable institutions may not be allowed as a deduction under the law.

(2) Any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property or estate.

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

(4) Premiums paid on anylife insurance policies covering the life of any officer or employe or of any person financially interested in any trade or business carried on by the taxpayer when the taxpayer is directly or indirectly a beneficiary under such policy.

(5) Interest paid or accrued within the year on money borrowed to purchase or carry securities or obligations (except United States obligations), the income from which is wholly exempt from tax, such as state or municipal bonds, etc., and

(6) Interest paid or accrued on indebtedness incurred or continued to purchase or carry obligations of the United States issued prior to September 24, 1917.

Credits Allowed. After the deductions have been made from the gross income, the net income is obtained and on this net income the individual may be required to pay two taxes, the normal tax, and the surtax. The amount of these taxes and the method of calculation will be explained later. It suffices for the present to know that in the calculation of the normal tax, the following items may be deducted from net income as defined above, although they are not deductible for the purpose of the surtax. In other words, after the net income is obtained, the items mentioned below may be subtracted and the remainder is the basis for the calculation of the normal tax, but if the individual has sufficient income to be subject to the surtax, it is calculated on the total net income without the consideration of the following credits:

1. The amount received as dividends from a corporation which is taxable under this title upon its net income and amounts received as dividends from a personal service corporation out of the earnings or profits earned prior to January 1, 1918.
2. The amount received as interest from the obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income as above discussed.
3. In the case of a single person a personal exemption of $1,000.00, or in the case of the head of a family or of a married person living with husband or wife, a personal exemption of $2,000.00. A husband and wife living together shall receive but one personal exemption of $2,000.00 against their aggregate net income, and if they make

separate returns, the personal exemption of $2,000.00 may be taken by either or may be divided between them.

4. $200.00 for each person (other than husband or wife), dependent upon and receiving his or her chief support from the taxpayer, if such dependent person is under eighteen years of age, or is incapable of self-support because mentally or physically defective.
5. In the case of a nonresident alien individual who is a citizen or subject of a country which imposes an income tax, the credits allowed in subdivisions three and four shall be allowed only if such country allows a similar credit to citizens of the United States not residing in such country. The law further provides that in case of a citizen or resident alien, a part of whose income is obtained from sources without the United States on which a tax is imposed by some other government, the amount of this tax may be deducted from the tax due under this law.

A, who is the holder of $185,000.00 liberty bonds, First 4s, is entitled to $35,000.00 exemption, with income of $6,000.00 on the balance of $150,000.00, and a personal exemption of $1,000.00, being unmarried. B is the holder of $210,000.00 of the same issue of bonds, $35,000.00 free of taxes, and $175,000.00, income on which is $7,000.00, and entitled to $2,000.00 personal exemption, being married. In both cases, the parties hold no other investments and have no other income. The bond issue in question is exempt from all normal tax, but is subject to graduated additional income tax or surtax on the interest on an amount of such bonds, the principal of which exceeds $35,000.00. The personal credits of $1,000.00 and $2,000.00, respectively, are allowed only for the purpose of computing the normal tax. There being no normal tax in the cases above, there are no such credits allowed. It is evident that in the first case there is an income of $6,000.00 (not $5,000.00), $1,000.00 of which is subject to a graduated additional income tax of $10.00; and in the second case, there is an income of $7,000.00 (not $5,000.00), $2,000.00 of which is subject to a graduated additional income tax of $30.00.

Making of Returns. The law provides that the individual may make his return either on the basis of a calendar or fiscal year. If his return is made on the basis of a calendar year, it must be filed with the Collector of Internal Revenue of the district in which he lives, on or before March 15 of the year following the one for which the return is made. If the return is made on the basis of a fiscal year, it must be made on or before the fifteenth day of the third month following the end of his

fiscal year. Forms for making this return can be secured from the Collector of Internal Revenue or the various substations which are usually established in connection with banks and similar institutions.

Every individual having a net income for the taxable year of $1,000.00 or over, if single, or if married and not living with husband or wife; or $2,000.00 or over, if married and living with husband or wife, shall make under oath a return specifically stating the items of income and deduction and credits allowed by law. If husband and wife living together have an aggregate net income of $2,000.00 or over, each shall make such a return unless income of each is included in a single joint return. If the husband and wife make a joint return, they are allowed the exemption of $2,000.00 or if they make a saparate return, either one may take an exemption of $2,000.00 or each may claim an exemption of $1,000.00. Whether they make a joint or separate return, their incomes will be considered separately in the calculation of the surtax.

It is held that a minor is an individual in the sense in which this term is used in the law and, therefore, if his income is in excess of $1,000.00 he must make a return or it must be made for him by his guardian or parent. If the minor does not make a separate return, his income must be included in that of his parent. Although the head of a family is permitted to claim an exemption of $2,000.00, he must file a return if his net income is in excess of $1,000.00, although it is not in excess of $2,000.00 and make a claim for the $2,000.00 exemption. A partnership must render a return showing the net income for the partnership and the partners to whom the profits are credited, although as previously mentioned, the partnership does not pay a tax as the partners are taxed individually for the profits received from the partnership.

Where to File Returns. Returns in the case of individuals shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return; or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

Extension of Time for Filing Returns. If for any reason return cannot be made by the due date, application may be made to the Collector of Internal Revenue for the district in which the taxpayer is located, setting forth the facts as to the taxpayer's inability to file on or before the due date, and upon a showing of a reasonable excuse, such as absence, sickness, etc., the collector will grant an extension of time not exceeding thirty days in which to file the return. If a further extension of time is required, application is to be made to the Commissioner of Internal Revenue at Washington, D. C. in the same manner. The Collector of Internal Revenue only has the power to grant an extension of time not exceeding

thirty days. The commissioner may grant an extension of time for filing returns on a reasonable cause shown, not exceeding six months, except in case of absence abroad.

When an extension of time has been granted, the date of the expiration of the period of extension shall be deemed to be the time fixed by law for filing the return. In any case in which the time for the payment of any installment is thus postponed because of an extension of time for filing the return, there shall be added, as a part of such installment, interest thereon at the rate of one-half of one per cent. per month from the time it would have been due, if no extension had been granted, until paid.

Rates of Tax. The law provides for two taxes on individuals—the normal tax and the surtax.

Normal—4% and 8%.

Surtax—Graduated rates—Same as in 1919.

Rates of Normal Tax on Individuals. There shall be levied, collected and paid upon the net income of every citizen or resident of the United States a normal tax at the rate of four per cent. upon the first $4,000.00 of net income in excess of the credits and at the rate of eight per cent. upon the remainder.

The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, on the basis of which the net income is computed.

Rates of Surtax on Individuals. In addition to the normal tax, there shall be levied, collected and paid for each taxable year upon the net income of every individual a surtax calculated at different percentages for different amounts of net income.

The surtax for 1920 is the same as it was for 1918 and 1919. It ranges from one per cent. of the amount by which the net income exceeds $5,000.00 and does not exceed $6,000.00 to 65 per cent. of the amount by which the net income exceeds $1,000,000.00. Accordingly, a taxpayer whose net income exceeds $1,000,000.00 may be subject to a tax of 73 per cent. of the amount by which his net income exceeds such sum. In computing the surtax, the taxpayer is not entitled to the credits against net income allowed for normal tax.

Computation of Tax. In the case of an individual citizen or resident, the normal tax is four per cent. on the first $4,000.00 over the personal exemption and credit for dependents, and eight per cent. upon the net income in excess of the first $4,000.00 plus credit for dependents and specific exemption.

To illustrate the computation of the tax for individuals, we shall assume certain propositions and show the calculations made in order to compute the total tax.

Proposition A

Assume that a citizen who is married and living with his wife has an income of $8,000.00 for the calendar year 1920. Compute the amount of his income tax.

Solution

Net income	$8,000.00
Exemption	2,000.00
Amount subject to normal tax	$6,000.00
Calculation of Normal Tax:	
4% on first $4,000.00	$ 160.00
8% on balance of $2,000.00	160.00
Total normal tax	$ 320.00
Additional Tax:	
Net income	$8,000.00
Exemption	5,000.00
Amount subject to additional tax	$3,000.00
Calculation of Additional Tax:	
$1,000.00 at 1%	$ 10.00
$2,000.00 at 2%	40.00
Total surtax	$ 50.00
Amount of Normal and Additional Taxes Payable:	
Normal	$320.00
Additional	50.00
Total tax	$370.00

Proposition B

Assume that the taxpayer in the preceding illustration and his wife, living together, had a joint income of $8,000.00, but of this amount $5,000.00 was his income and $3,000.00 was his wife's income. Compute the tax and show whether it would be advantageous to file a combined return or separate returns.

Solution

In the form of combined returns:	
Income of husband and wife	$8,000.00
Marital exemption	2,000.00
Net income subject to normal tax	$6,000.00
Calculation of normal tax:	
4% on first $4,000.00	$ 160.00
8% on balance of $2,000.00	160.00
Total normal tax	$ 320.00

In the form of separate returns:

Wife's income— $3,000.00. Husband's income—$5,000.00

Husband and wife divide the exemption of $2,000.00 ($1,000 00 each.)

Wife	$3,000.00	Husband	$5,000.00
Share of exemption	1,000.00	Share of exemption	1,000.00
Amount taxable	$2,000.00	Amount taxable	$4,000.00

Husband, $4,000.00 at 4%	$ 160.00
Wife, $2,000.00 at 4%	80.00
Total normal tax of husband and wife	$ 240.00

Apparently there is an advantage in filing separate returns.

The surtax is actually an additional tax, being levied in addition to the normal tax, and when referred to as either additional tax or surtax, has the same meaning. As the husband's income is $5,000.00, he is not liable for any additional tax, his income not being in excess of $5,000.00. As the wife's income is only $3,000.00, no additional tax is due for her income does not exceed $5,000.00; therefore, no additional tax would be paid upon the joint income of the husband and wife, only the normal tax being assessable. No additional tax is due upon the income of either husband or wife unless either his or her income exceeds $5,000.00 individually.

Payment of Tax. The tax may be paid in four installments, covering the entire year, up to December 15, 1921. The first payment is due at the time of filing the return, that is, March 15, 1921, if the return is made on the basis of the calendar year 1920. The second payment is to be made on June 15, the third payment on September 15 and the fourth and final payment on December 15.

Penalties. For failure to render returns, whether of income, withholding, or information, at the proper times, for understating the income or tax, and for failure to pay the tax or installments of it when due and payable, the statute prescribes various penalties. These include severally or in combination the addition of interest to the tax, and the addition of specified percentages of the tax and the imposition of fines. If the failure to file a return or list is due to sickness or absence, the collector may allow an extension of time not exceeding thirty days for making and filing the return or list.

INCOME TAX QUESTIONS AND PROBLEMS

1. Are domestic partnerships obliged to make income tax returns? Inst. Ex.

2. To what extent are losses deductible in computing net income for federal taxes in the case of a resident individual? Inst. Ex.

3. A widowed mother died, leaving three children under 15 years of age. An unmarried uncle took charge of the children on January 1, 1919, and supported them during the year.

The income of the uncle consisted of:

Dividends received from corporations, from surplus accumulated since January 1, 1912, of $1,000.00 each year	$8,000.00
Interest received on $5,000.00 Fourth Liberty Bonds	212.50
Net Income from farming operations	1,000.00
Total income	$9,212.50

Prepare statement showing the amount of federal tax liability. C. P. A. Ex.

4. Mr. Richard Roe, a married man, requests you to prepare his federal income tax return for the ten months ended December 31, 1920, from the following information which he has submitted to you:

Income Received During the Year

Salary	$5,000.00
Directors' fees	105.00
Rent of property (net)	7,596.54
Interest on investments	1,648.32
Dividends on bank stock	2,500.00
Dividends on stock held in industrial companies	11,500.00
Dividends on stock of a corporation organized and doing business in a province of Canada	1,500.00

He has paid out:

Interest on his personal indebtedness	$2,500.00
Taxes on income-producing real property	1,600.00
Taxes on real property not producing income	400.00
Personal household expenses	2,500.00

He also reports:

Loss of a dwelling house, from which he had received rents, by fire, no insurance being carried		$1,200.00
Judgment rendered against him in his suit to collect on the past due note of Harry Hanson—		
Principal	$ 2,000.00	
Interest	320.00	
Legal expenses	150.00	$2,470.00

Prepare statement showing computation of tax. The rates for individual taxes for 1920 were:

First $4,000.00—4%; thereafter—8%.

Surtax

Incomes	Per cent.
$ 5,000.00 to $ 6,000.00	1
6,000.00 to 8,000.00	2
8,000.00 to 10,000.00	3
10,000.00 to 12,000.00	4
12,000.00 to 14,000.00	5
14,000.00 to 16,000.00	6
16,000.00 to 18,000.00	7
18,000.00 to 20,000.00	8
20,000.00 to 22,000.00	9
22,000.00 to 24,000.00	10
24,000.00 to 26,000.00	11
26,000.00 to 28,000.00	12
28,000.00 to 30,000.00	13

A married man is entitled to an exemption of $2,000.00.

Inst. Ex.

Chapter Fourteen

FEDERAL INCOME TAXES

THE INCOME TAX ON CORPORATIONS

Corporations Subject To Tax. All corporations* not exempted are taxable on their net income. A few special applications may be given by way of illustration. In case of a holding company with various subsidiary companies, the old law required that a separate return be made by each company and that each company pay a separate tax on its income. The new law provides that under regulations prescribed by the Commissioner of Internal Revenue, subsidiary companies shall have their income combined in one joint return made by parent or holding company, that they shall pay one tax, and have one exemption. Although a corporation may be owned by an exempt corporation, that does not exempt it from the payment of the tax if it does not belong to the classes mentioned above. Corporations in existence only part of a year must file a return for that portion of the year. Such a case may arise where the corporation is organized within the year or where a corporation previously organized is dissolved within the year. Corporations fully organized must file a return whether they are doing business or not, and this applies equally to newly organized corporations which have not commenced business, and corporations which have formerly done business and have ceased to do so. Corporations not fully organized need not file a return. Corporations engaged in agricultural pursuits for profits must file a return the same as those engaged in mercantile industries. Corporations which lease part of their property to others, with the agreement that the rentals are to be paid directly to the stockholders, must consider the amount so paid as income and report it in their returns. Private banks must render returns if they have the corporate form of organization, but need not make a return if they are organized as a partnership or the bank is owned or operated by an individual.

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*The term "corporation" refers not only to the ordinary statutory corporations, but also to business trust associations called "Massachusetts Trust," joint stock companies, limited partnerships, mutual saving banks and insurance companies, and all analagous business associations, the net income of which is distributed among the members on the basis of the shares which each holds, or the proportion of capital which each has invested. Corporations organized in this country are taxed upon their income received from all sources. Corporations organized in foreign countries are taxable on the net income received from sources in this country only.

Net Income. The net income of a corporation is obtained in the same manner as that of an individual—by subtracting from the gross income the deductions which the law permits to be made. It is, therefore, necessary to see what is included under the gross income of corporations and the deductions which are permitted. The income which is exempt from tax in the hands of the individual, as previously explained, is also exempt in the hands of a corporation.

Gross Income. The law provides that "in the case of a corporation subject to the tax imposed by Section 230, the gross income means the gross income as defined in Section 213 (which is the section which defines the gross income of the individual) except that:

1. In the case of life insurance companies there shall not be included in gross income such portion of any actual premium received from any individual policyholder as is paid back or credited to or treated as an abatement of premium of such policyholder within the taxable year.
2. Mutual marine insurance companies shall include in gross income the gross premiums received by them, less the amounts paid for reinsurance.
3. In case of a foreign corporation, the gross income includes only the gross income from sources within the United States."

Gross Income of Corporations. Although the gross income of corporations is defined by the act to be the same as the gross income of an individual, except as mentioned above, there are a few particular points worthy of notice which have not been mentioned in the previous discussion of the gross income of individuals. For the purpose of convenience in discussion, the gross income of corporations may be classified as follows:

1. From operations.
2. From rentals and royalties.
3. From interest.
4. From dividends.
5. From other sources.

Income from Operations. In arriving at the gross income from operations, the gain or loss is determined by the inventory method. The sales should be shown net; that is, any deductions which have been made in the way of return sales, allowances, or abatements, should be subtracted. The inventory should be taken at cost or market price, whichever is the lower. *This refers, of course, only to the inventory of stock-in-trade, for in the case of securities and similar properties, the cost price must be taken, except in the case of a dealer in securities, where the

*A taxpayer may, regardless of his past practice, adopt the basis of "cost or market, whichever is lower," for his 1920 inventory, provided a disclosure of the fact and that it represents a change is made in the return. (T. D. 3108, Dec. 30, 1920.)

market price may be used. The inventory may be either a physical inventory or it may be a book inventory, if the latter method is in current use by the firm in question. Purchases should be shown net; that is, less any returns or allowances, but freight and drayage in may be added to the invoice cost of same. After the above amounts have been obtained, the gross profit is arrived at by subtracting from the sales, plus the inventory at the end of the year, the purchases made during the year, plus the inventory at the beginning of the year. The above is the method outlined in the Treasury regulations. The same result is obtained, of course, by adding the purchases during the year to the inventory at the beginning of the year and subtracting the inventory at the end of year, thus obtaining the cost of goods sold, which is subtracted from sales to obtain the gross profit. In case of a manufacturing concern, there are three inventories to be considered—that of raw materials, goods in process, and finished goods. The same method should be followed in arriving at their value, cost or market price, whichever is lower, being used.

Income from Rentals and Royalties. All receipts for rent, whether in cash or its equivalent, must be reported as part of the gross income. If a tenant makes improvements or repairs on the land, which it is the duty of the landlord to make in lieu of rent, the cost of these must be considered as an addition to the rent received. Where permanent improvements are made which revert to the owner at the termination of the lease, their value, less the accrued depreciation, must be regarded as income. All amounts received as royalties from patents, copyrights, or similar privileges must be reported as income, but a reasonable allowance for depreciation thereon may be deducted. In the case of mines, which are operated on the royalty basis, a reasonable allowance for depletion, as explained later, may be made.

Income from Interest. All interest received or accrued should be reported, except:

1. Interest on obligations of a state or a political subdivision thereof.
2. Interest on obligations of the United States issued prior to September 1, 1917, and the interest on the obligations of the United States issued since September 1, 1917, to the extent provided for in the acts authorizing their issue.
3. Interest on securities issued under the Foreign Loan Act of 1916.

Income upon bonds should include only the interest earned from the date of purchase. Where bonds are purchased between interest dates, the amount paid for accrued interest should be deducted from interest received. When bonds are purchased at a premium or discount, the amount of the premium or discount should be amortized over the life of the bonds and only a portion of the addition or deduction derived therefrom considered during the current period. In the case of interest re-

ceived on securities held in a sinking fund, this must be reported as income of the corporation.

Income from Dividends. In general, all dividends received by a corporation must be included in its gross income. Under the head of deductions, it will be explained that the amount of dividends received from corporations, which are themselves subject to the income tax, may be treated as a deduction by the company receiving the dividends. However, they must be reported in stating gross income and taken as a deduction under the proper heading. Dividends on stock of federal reserve banks are held as exempt from the tax and need not be reported. As previously explained, stock dividends are not subject to the tax.

Income from Miscellaneous Sources. If a deduction has been claimed on account of a bad debt which has been written off, and this debt has been later collected, it must be reported as income in the year when collected. Assessments made by a corporation on its stockholders are not considered as income by the receiving corporation, but are considered as additional investment on the part of the stockholders, consequently, they are not counted as income by the corporation, nor can they be treated as a deduction by the individual paying them. If the corporation buys its own bonds at a discount, it is held that the savings thus made must be treated as income. If assets are traded for capital stock of another corporation, the difference in the cost of the assets and the value of the stock received is regarded as income. However, if the stock of one corporation is exchanged for capital stock of the same par value of another corporation, it is deemed that no profit arises as a result thereon. Amounts received from insurance policies held by the corporation less the premiums previously paid are regarded as income. No appreciation of assets is recognized by the income tax law, therefore, if a corporation writes up its assets and credits the amount arising as a result thereon to its Surplus account, this is not regarded as income.

In the same manner no appreciation nor depreciation of good will is recognized. However, if the good will of a corporation is sold at a greater value than it cost, the difference is reportable as income. If capital assets of a corporation are sold, the difference between their cost price and sales price is reported as income if purchased since March 1, 1913. If purchased prior to that date, the difference between their market value on March 1, 1913, and their sales price is regarded as income.

Foreign Corporations. Foreign corporations are taxable only upon income derived from sources within the United States, including the interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations and including all amounts received (although paid under a contract for the sale of goods

or otherwise) representing profits on the manufacture and disposition of goods within the United States, Foreign corporations are not allowed the specific exemption of $2,000.00 for income tax, nor $3,000.00 for excess profits tax.

Corporations Exempt from the Income Tax. The law provides that the following corporations are exempt from the income tax:

1. Labor, agricultural, and horticultural organizations.
2. Mutual savings banks not having stock represented by shares.
3. Fraternal, beneficiary societies, orders, or associations, organized and operated for the mutual benefit of their members.
4. Domestic building and loan associations and co-operative banks without capital stock organized and operated for mutual purposes and without profit.
5. Cemetery companies owned and operated exclusively for the benefit of their members.
6. Corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to any specific individual.
7. Business leagues, chambers of commerce, or boards of trade not organized for profit.
8. Civic leagues, or organizations not organized for profit, but operated exclusively for the promotion of social welfare.
9. Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable enterprises, no part of the net earnings of which inures to any stockholder or member.
10. Farmers' or other mutual associations—
    (a) Hail, cyclone, or fire insurance companies.
    (b) Ditch or irrigation companies.
    (c) Telephone companies.
    (d) Like organizations of purely local character, the income of which is collected merely for the purpose of meeting expenses.
11. Farmers' and fruit growers' associations, if organized and operated as sales agencies for the purpose of marketing products of their members and turning back to them the proceeds of sales less the necessary selling expenses on the basis of the quantity of products furnished them.
12. Corporations organized for the exclusive purpose of holding title to property, the net income from which is to be turned over to an organization which itself is exempt from the tax.

13. Federal land banks and national farm loan associations created under the Act of July 17, 1916, to provide capital for agricultural development.
14. Personal service corporations.

Personal Service Corporations. For tax purposes, personal service corporations are treated as partnerships, and are not as such liable to income tax, but the stockholders must include in their returns the proportionate part of the earnings of such corporations, whether received as dividends or not, according to the respective stock holdings. Foreign personal service corporations shall not be accorded the privileges of domestic personal service corporations, but shall be taxed as corporations.

A personal service corporation is a corporation whose income is due primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor. For instance, a corporation composed of commission merchants or advertising men, whose principal owners or stockholders are themselves actively engaged in the conduct of the business, whose income is due principally to their personal services, and whose capital is employed for the purposes of paying for office equipment and employes' salaries, is a personal service corporation.

In the case of a personal service corporation, if 50 per cent. or more of the gross income consists of (1) gains derived from trading as a principal, or (2) gains, profits or commissions derived from Government contracts, made between April 6, 1917, and November 11, 1918, both dates inclusive, it shall not be treated as a personal service corporation subject to the provisions which apply to a partnership, but shall be taxed as a corporation.

Every personal service corporation, although not subject to the tax, must file a return showing the gross income, the deductions allowed by law, the net income and the amounts distributed, with the names and addresses of the recipients. Where a part of the net income has not been distributed, the names and addresses of the stockholders who would be entitled to the profits if distributed must be given, with the portion assignable to each.

Stockholders Taxable as Partners. The individual stockholders of personal service corporations shall be taxed in the same manner as the members of partnerships, and all the provisions of the Act relating to the partnerships and members shall, so far as practicable, apply to personal service corporations and their stockholders. Any portion of the net income remaining undistributed at the close of the taxable year shall, for the purpose of taxation, be assigned to the stockholders in proportion to their respective shares.

Deductions from Income. In many ways the deductions allowed to corporations are very similar to the deductions allowed to individuals but there are certain differences for two reasons:

1. The individual's income usually is derived chiefly from services and, therefore, there are few expenses which the individual can deduct, while income of the corporation is derived from operations of the business and, therefore, there are numerous expenses which can be deducted.
2. There are some items which the individual is permitted to deduct which the corporation cannot deduct and vice versa; consequently, it is thought worth while to discuss deductions allowed to corporations separately from deductions allowed to individuals. This will, of course, involve a repetition of what has already been said to some extent.

The expenditures of a corporation may be divided into two classes:

1. Capital expenditures.
2. Revenue expenditures.

Capital expenditures add to the value of some asset and are not deductible from the gross income. Revenue expenditures are those which are incurred in connection with earning the gross income of a corporation and are a proper deduction in determining its net income.

Classification of Deductions. As a matter of convenience in discussion, the deductions allowed a corporation may be classified as follows:

1. Ordinary and necessary business expenses.
2. Interest and taxes.
3. Losses.
4. Depreciation and depletion.
5. Deductions by insurance companies.
6. Miscellaneous.

Ordinary and Necessary Business Expenses. The expenses of a corporation may be deducted on the accrual basis if the gross income is reported on the same basis. Prepaid expenses should be deferred and treated as a deduction in the year to which they apply. Illustrations of these are: Prepaid insurance, taxes, interest, advance payments on contracts, etc. Expenses paid in property or stock are deductible the same as if paid in cash. If capital stock is given in payment for services rendered, the fair market value of the stock at the time of delivery can be deducted as an expense. All salaries and wages payable by the corporation are deductible, whether paid in cash, property or stock. Salary and wages in order to be deducted, however, must be entered as an expense on the books of the corporation. In the case of salaries of

officers and employes, who are stockholders in the company, the regulations prescribe that they will be given careful scrutiny, and if considered too large, they will be regarded as a distribution of profits instead of an expense. Salaries paid soldiers or sailors in the service of the Government are regarded as a legitimate expense and may be deducted.

Pensions paid to retired employes are regarded as a deductible expense. Gifts to employes are not deductible. Bonuses paid to employes may be deducted when they are made in good faith as additional compensation for services rendered. If made as a gratuity or gift, they cannot be treated as an expense. Souvenirs given to customers are deductible as an advertising expense. Campaign contributions and lobbying expenses are not allowable. If donations are made subject to a condition that certain services may be received in return, they may be treated as an expense and deducted accordingly. For instance, donations to a hospital in consideration of an agreement by the hospital that a ward will be provided for the use of the employes of the company has been held as an allowable deduction. Donations made for obtaining good will are held not to be deductible. This ruling seems to be arbitrary, since in many cases such payments are proper expenses on the part of a corporation. For instance, it has been held that prizes offered at a county fair could not be treated as an expense by the firms who offered them. This would seem to be making quite an arbitrary distinction, but under the present ruling they must be excluded in arriving at the proper expense of the firm.

Money spent by salesmen in entertaining customers of the company is held an allowable expense. The distinction between a gratuity and an expense is sometimes hard to make. The general theory is that if an expense is made from which no benefit accrues to the corporation, either directly or indirectly, it cannot be treated as a deduction, but if the corporation expects to obtain a return as a result therefrom, it can be treated as a deductible expense. In the case of expenses incurred in making ordinary and incidental repairs to property, a reduction may be made, but if the expenditure results in prolonging the life of the asset or appreciably increasing its value, it is treated as an additional investment and can not be deducted. Premiums on life insurance paid by a corporation on the life of its officers or employes can not be deducted at the time paid, but they can be subtracted from the amount received when the policy is paid.

The Treasury Department has ruled that organization expenses are a capital expense. They are neither deductible nor subject to depreciation. This, however, is contrary to their treatment by accountants, who regard them as an expense which should be written off against income as soon as possible. All ordinary rental and royalty payments are deductible, as are also expenses incurred in making any improvements de-

manded by the lease. The cost of the latter, of course, should be prorated over the years during which they are used. If interest or dividends are paid to stockholders in lieu of rent, they may be deducted the same as if rent was paid.

Interest and Taxes. Interest paid on indebtedness of corporations may be deducted, whether paid in cash or its equivalent. It may be reported either on the accrual or cash basis, depending on the method pursued by the corporation in reporting its expenses. Interest paid on money borrowed to purchase securities, the income from which is exempt, except securities of the United States Government, is not deductible. For instance, if a corporation should borrow money to buy municipal or state bonds, the interest on which is exempt from the income tax, the interest paid on such money would not be deductible.

All taxes paid or accrued within the taxable year are deductible except:

1. Special assessments which are deemed to increase the value of the property to which they pertain.
2. Inheritance taxes.
3. Income and excess and war profits taxes. For instance, all taxes imposed by states and political subdivisions thereof and by the United States Government, except as mentioned above, are deductible. This includes excise and franchise dues, custom duties, etc. Accrued taxes are deductible, and if the exact amount is not known, an estimated amount, therefore, is deductible.

Losses. The new law provides that the following losses may be deducted by a corporation:

1. Losses sustained during the taxable year and not compensated for by insurance or otherwise.
2. Debts ascertained to be worthless and charged off within the taxable year.

It has been previously explained how losses in connection with stock-in-trade is determined by means of the inventory method. In connection with securities, no loss can be claimed, except in case of a dealer in securities, unless the securities are disposed of and an actual loss realized. In connection with the sale of property, it has also been explained how the profit or loss is ascertained. There has been much criticism of the department's ruling in connection with the treatment of bad debts. It is the custom of accountants to estimate at the end of the fiscal period the loss incurred because of uncollectible accounts receivable and to record this amount on the books as a deduction from income of the current period. The Treasury Regulations, however, will not permit such an estimated amount to be treated as a deduction, but will only permit a deduction on account of bad debts when a debt has actually been ascertained to be worthless and written off the books.

Some difficulty has arisen as to when a debt is ascertained to be worthless. On this point the Treasury Department has ruled that a debt may be regarded as ascertained to be worthless when it is determined beyond reasonable doubt that it cannot be collected. With reference to bonds, since they are regarded as debts of a corporation, they may be written off if it is ascertained without reasonable doubt that they are uncollectible. They are, therefore, treated somewhat differently than stock and other securities since no losses can be claimed on the latter until they are actually disposed of. Discount on bonds incurred in their sale may be treated as a deduction and prorated over the life of the bond. Discount on stock, however, is regarded as a capital loss and cannot be treated as a deduction. The old law held that a holding company must show all profits which had accrued to it on the books of subsidiary companies, but could not treat as a deduction losses, similarly incurred, until the assets of the holding company were reduced as a result thereof. The new law, however, provides for a consolidated return to be made by the holding company, therefore, both losses and gains can be considered therein.

Depreciation and Depletion. The present law provides that "a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business, including a reasonable allowance for obsolescence" may be treated as a deduction. A distinction must be made between depreciation and fluctuation. Depreciation is the decline in the value of property as a result of its use in the business. Fluctuation is a change in the market value of assets, either favorable or unfavorable, which is due to causes apart from the business. The former is an allowable deduction, while the latter is not considered. A distinction must also be made in connection with depreciation between repairs and renewals.

The expense of repairs may be treated as a deduction in addition to the allowance made for depreciation, but the same rule does not apply in the case of renewals. The regulations prescribe that they must be charged against the reserve for depreciation, therefore, cannot be treated as a deduction. In other words, a renewal is regarded as a capital expenditure as defined above. In arriving at the rate of depreciation, three things must be considered,—the original cost of the asset, the estimated life of the asset, and the residual value of the asset. Neither the law nor the regulations of the Treasury Department prescribe the rate of depreciation, which is permissible. Both say that a "reasonable" rate is allowable. Collectors of internal revenue and inspectors of the department have, however, indicated their approval of certain rates. In certain cases known by the author, they have stated that two or three per cent. may be charged on wooden or frame buildings. They have also permitted a rate of ten per cent. on furniture and fixtures, and in some cases as high as twenty per cent. on certain kinds of ma-

chinery. However, they look with suspicion on high rates of depreciation and the tendency in the past has been for them to be overconservative rather than otherwise. Only assets employed by the corporation in its business are subject to depreciation. All assets so employed, both tangible and intangible, except good will and organization expenses, are regarded as subject to the depreciation provision.

The amount of depreciation claimed must be entered upon the books of the corporation. It may be credited to the asset account to which it refers, or it may be credited to a reserve account. The latter is, of course, the approved accounting method and should be followed in recording the depreciation. In the old law no mention was made of obsolescence, but the Treasury Department ruled that obsolescence could be considered in arriving at depreciation. In the new law, specific mention is made of obsolescence as an allowable deduction. It can probably be best considered in estimating the life of the asset as mentioned above. In reference to depletion, the present law reads as follows: "In case of mines, oil or gas wells, or other natural deposits and timber, a reasonable allowance for depletion and depreciation of improvements according to the peculiarities of each case, based upon the cost, including cost of development not otherwise deducted," may be treated as a deduction. The Treasury Department has issued detailed rulings as to how the amount of depletion is to be calculated. The following important points may be mentioned:

1. If the property was acquired prior to March 1, 1913, the fair market value at that date is taken as the basis for calculating the depletion.
2. If acquired by purchase since the above date, the cost price is taken as the basis.
3. If "discovered" since the above date, the market price thirty days after "discovery" is the basis.

A distinction must be made between depreciation and depletion. Depreciation means the lowering of value due to wear and tear. Depletion is the decrease or lowering of the supply of the natural deposit. Generally speaking, the depletion may be calculated as follows:

1. Determine the original value as stated above.
2. Determine the total number of units and by division, the unit cost.
3. Multiply the number of units produced during the taxable period by the unit cost and treat this as the depletion charge.

The amount of depletion claimed must be entered upon the books the same as in the case of depreciation. As previously stated, detailed regulations in regard to the depletion of mines, etc., have been issued by the Treasury Department and can be obtained on request.

Deductions by Insurance Companies. The law provides that in the case of insurance companies, the following deductions may be made:

1. The net addition required by law to be made within the taxable year to reserve funds.
2. Sums that are paid as dividends within the taxable year on policy and annuity contracts.
3. Further deductions in connection with first, companies issuing policies regarding life and accident insurance combined in one, and second, further deductions in connection with mutual marine and insurance companies. Details in regard to the deductions mentioned under the last subhead may be obtained by reference to the law and from the regulations of the Treasury Department.

Miscellaneous Deductions. Amounts received as dividends from a corporation which are taxable under the income tax law upon its net income and amounts received as dividends from a personal service corporation out of earnings or profits accrued prior to January 1, 1918, may be treated as a deduction by the corporation receiving them. In case of anticipated losses, the company may claim a deduction by filing a statement giving details in reference to the anticipated loss and providing a bond to cover the amount of the tax which will be due if the loss does not occur as anticipated. When the loss is actually incurred or it is found that the claim is erroneous, an adjustment will be made.

Items Not Deductible. The law provides that in computing the net income of a corporation, no deductions shall be allowed which are declared nondeductible in connection with the income of an individual. As previously mentioned, the following items are declared as not deductible by an individual, therefore, they are not deductible on the part of a corporation:

1. Personal, living or family expenses. These, of course, would not arise in connection with a corporation.
2. Amounts paid for buildings or permanent improvements.
3. Any amount expended in reconstructing property for which depreciation has been allowed.
4. Premiums on a life insurance policy covering life of officer or employe.

Organization Expenses. Expenses of the organization of a corporation, such as incorporation fees and attorney and accountant's charges, constitute investments of capital and are not deductible from gross income.

Donations. Corporations are not entitled to deduct from gross income contributions made to religious, charitable, scien-

tific or educational corporations, even though such contributions are made to the Red Cross or other war activities.*

Credits Allowed. The following credits are allowed by the present law:

1. Amounts received as interest upon the obligations of the United States and bonds issued by the War Finance Corporation prior to September 1, 1917, and on obligations and bonds issued subsequent to September 1, 1917, to the extent provided for in the acts authorizing their issue.
2. The amount of the excess profits tax imposed by the revenue bill of 1917, or of subsequent acts of Congress.
3. In the case of domestic corporations a specific exemption of $2,000.00.

The Rate of the Tax. The income tax imposed by the present law is twelve per cent. on the net income of the corporation as above defined, less the credits allowed, for the year 1918, and ten per cent. on the same for the year 1919 and each year thereafter.

Calculation of the Tax. The calculation of the income tax of the corporation is quite simple after the amount on which it is imposed has been determined. The gross income, as above defined, is stated, the deductions that are allowable are made, and this gives the net income of the corporation. From this net income the credits permitted are subtracted and the income tax for the year of 1919 and each year thereafter, is ten per cent. of the remainder.

Place for Filing Returns. The law further provides that "returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland."

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*A tax decision made December 27, 1920, provides that it will not be necessary for corporations to file amended returns in case contributions to Red Cross or other recognized war organizations were deducted in the returns for the year 1918. This rule is made for the benefit of those corporations which filed their returns and claimed such deduction prior to the issuance of Treasury Decision 2847.

In order to obviate the necessity of filing amended returns for the year 1918, these corporations should file immediately with the Collector of Internal Revenue a statement showing the amount of such deductions claimed, the amount of the net income as reported and as corrected, and the amount of additional tax due by reason of the erroneous claiming of the deduction. The total amount of additional tax shown to be due by such statement should be paid at once, together with interest on each installment from the original due date.

Returns and Payment of Tax. A corporation must file the return for the excess profits tax at the same time it files the return for the income tax. As previously explained, the corporation may report on the basis of either a calendar or a fiscal year. If it reports on the basis of a calendar year, the return must be filed by March 15 of the year following the one covered by the return. If the return is made on the basis of a fiscal year, it must be filed by the fifteenth day of the third month after the end of the fiscal year. The return is filed with the Collector of Internal Revenue of the district in which the corporation has its principal office. In the case of a foreign corporation, the return should be filed with the Collector of Internal Revenue of the Baltimore District.

The income and excess profits taxes are due in four equal installments on March 15, June 15, September 15, and December 15. Except for the first installment, which is due without any bill or notice, payment need not be made until notice of assessment has been given. Payment of the whole tax may be made on or before the due date of the return, but no discount is allowed where the return is filed on a fiscal year basis, the installments are due when the return is due and on the fifteenth days of the third, sixth, and ninth months thereafter.

There are penalties imposed for a failure to make the return at the proper time, the making of a false return or the failure to pay installments when due. It is not thought worth while to discuss these here. Detailed information with reference thereto can be found in the Treasury Regulations and the Law.

INCOME TAX QUESTIONS AND PROBLEMS

1. What constitutes a personal service corporation?
C. P. A. Ex.

2. Name two conditions under which corporations should file consolidated returns and the requirements of evidence of affiliation. C. A. P. Ex.

3. Are contributions made by a corporation to religious, charitable, scientific or educational corporations deductible from gross income for purpose of ascertaining net taxable income?
C. P. A. Ex.

4. To what extent are salaries of officers and bonuses given to employes deductible in computing the net income of corporations under the federal income tax law? Inst. Ex.

5. A New York corporation received during the year dividends amounting to $2,000.00 on stock of a Massachusetts corporation owned by it and $1,000.00 on stock of a British corporation owned by it.

Do these dividends constitute taxable income of the New York corporation under the federal income tax law?
Inst. Ex.

6. In the preparation of consolidated returns under the federal income tax law, on what basis would you apportion the tax among the several corporations? Inst. Ex.

7. Designate the following named expenses that are allowable deductions in computing the income tax of a domestic corporation:

1. Donation to American Red Cross.
2. Donation to a local hospital.
3. Donation to the County Fair Association.
4. Donation to committee for paying expenses for political convention to be held in home town.
5. National Political Campaign Expenses.
6. Local Political Campaign Expenses.
7. Fine for violation of Child Labor Laws.
8. Membership fee of Chamber of Commerce.
9. Life insurance premiums on lives of officers, the corporation the beneficiary.
10. Life insurance premiums on lives of officers who are the beneficiaries. C. P. A. Ex.

8. A corporation owned the following bonds for one year ending December 31, 1920. What amount of interest would be allowed as a deduction in computing its taxable income?

First Liberty Bonds, 3½ per cent...........	$10,000.00
First Liberty Converted, 4 per cent..........	10,000.00
First Liberty Converted, 4¼ per cent........	10,000.00
Second Liberty Converted, 4¼ per cent......	10,000.00
Third Liberty Converted, 4¼ per cent.......	10,000.00
Fourth Liberty, 4¼ per cent................	10,000.00
Victory Liberty, 3¾ per cent...............	10,000.00
Victory Liberty, 4¾ per cent...............	10,000.00
North Carolina State Bonds, 5 per cent......	10,000.00
City of New York Bonds, 4 per cent.........	10,000.00
County of Mecklenburg, N. C., 4½ per cent..	10,000.00

C. P. A. Ex.

9. A corporation owns and operates a rolling mill. In its expense accounts for 1920 are the following items of disbursement:

$1,000.00 to Red Cross for services of nurse and for medicines at the mill's emergency hospital;

$500.00 to the war chest (a local community fund);

$100.00 annual dues in National Mill Owners' Association;

$500.00 to a local hospital for beds provided solely for the use of employes of the corporation;

$250.00 to the Society for the Prevention of Cruelty to Children.

Specify which, if any, of these items the corporation may deduct from its gross income in determining its taxable income.
Inst. Ex.

10. In 1909 A and B formed a corporation for the purpose of conducting the business then carried on by them under a partnership, the capital stock being divided equally. B died on June 1, 1917, bequeathing his shares of stock to his son Z by will. Because of B's death, the corporation ceased active business and began to liquidate. From time to time assets were disposed of and dividends were declared and paid from the moneys received. What is the status of such dividends for federal income tax purposes

(a) As regards A?

(b) As regards Z? Inst. Ex.

Chapter Fifteen

FEDERAL EXCESS PROFITS TAXES

The excess profits tax is a tax imposed on the income of corporations in addition to the income tax previously explained. It is a tax on the excess of the net income for the taxable year over a certain percentage of the invested capital of the taxable year, plus a specific exemption of $3,000.00. In other words, the excess profits tax proceeds on the theory that every corporation is entitled to $3,000.00 plus a certain percentage of its invested capital as free from the excess profits tax, while all profits in addition to this are subject to the excess profits tax.

In order to determine the amount of the tax, it is necessary to consider two things:

1. The net income for the taxable year.
2. The invested capital for the taxable year.

Net Income for the Taxable Year. The net income for the taxable year consists of the gross income less deductions. It is determined in the same manner as the net income for the purpose of the income tax as is discussed in the preceding pages, consequently, it is not necessary to discuss it further at this time.

What is Invested Capital? The chief difficulty in ascertaining the excess profits tax is the determination of the invested capital of the business. In order to discuss properly the determination of invested capital, it is necessary to understand the definition of the following terms:

1. Tangible property.
2. Intangible property.
3. Borrowed capital.
4. Invested capital.
5. Admissible assets.
6. Inadmissible assets.

Tangible Property. "The term 'tangible property' means stocks, bonds, notes, and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property."

Intangible Property. "The term 'intangible property' means patents, copyrights, secret processes and formulas, good will, trade-marks, trade-names, franchises, and other like property."

Borrowed Capital. "The term 'borrowed capital' means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise."

Invested Capital. Invested capital means practically owned capital. In other words, it means the capital which the owners of the business have invested in the business. However, the law holds that the capital which the owners have invested must be represented by the proper kind of an asset in order that a certain amount of income arising from the use of this capital may be exempted from the tax. In other words, the law limits the kind of assets in which the capital of the business may be invested, if the owners of the business are to claim a certain rate of income on this capital as exempt from the excess profits tax.

Admissible Assets. "The term 'admissible assets' means all assets other than inadmissible assets, valued in accordance with the provisions of subdivision (a) of Section 326, Section 330, and Section 331 of the law."

Inadmissible Assets. "The term 'inadmissible assets' means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, but where the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under paragraph (2) of subdivision (a) of Section 234 of the law, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets."

Computation of Invested Capital. The basis for the computation of invested capital is the net worth of the business. If a Balance Sheet of the business is made showing its assets and its liabilities, the difference between the two will represent its net worth. The net worth of a corporation consists of its capital stock plus its paid-in, or earned surplus, and this is the basis for computation of invested capital. The law, however, requires that certain adjustments be made before the sum of the capital stock and surplus may be regarded as invested capital of the business. To make these adjustments, it is necessary to know how the stock of the company was issued and how the surplus of the corporation was created. It will be necessary, therefore, to notice first the adjustments which must take place in connection with the Capital Stock account, and second, the adjustments which must take place in connection with the Surplus account.

Assets which may be Included in Invested Capital.

(1) Actual cash bona fide paid in for stock or shares.

(2) Cash value of tangible property paid in for stock or shares at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless it is shown to the satisfaction of the commissioner that the actual cash value of such property was really and

substantially in excess of the par value of the stock or shares at the time paid in.

(3) Paid-in or earned surplus or profits earned prior to the taxable year.

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding either the actual cash value of such property at the time paid in or the par value of the stock or shares issued therefor or in the aggregate not exceeding 25% of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lower.

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding either the actual cash value of the property at the time paid in or the par value of the stock or shares issued therefor or in the aggregate not exceeding 25% of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lower.

In no case shall the value of intangible property paid in for stock or shares, whether paid in prior to or subsequent to March 3, 1917 (the date of inception of the first Excess Profits Tax Act), exceed 25% of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year.

Adjustments of Capital Stock Account. Capital stock may be issued for three kinds of property:

1. Tangible property.
2. Intangible property.
3. Mixed tangible and intangible property.

It will be necessary to discuss the adjustments which may take place when stock is issued for each kind of property.

Stock Issued for Tangible Property. If stock is issued for tangible property and the actual cash value of the property at the time of its receipt was less than the value of the stock, the difference between the value of the property and the par value of the stock must be deducted from the net worth of the business in determining its invested capital. If, on the other hand, the value of the tangible property received was more than the par value of the stock issued, the excess may be added to the net worth of the business in determining the invested capital. This may be done, however, only when it is proven to the satisfaction of the commissioner that the value of such property was in excess of the par value of the stock issued. If the commissioner permits the adding of such an amount to the net worth of the business, he must make a record of the granting of such permission and furnish such a record to Congress, if requested. The fact that such a record is required is an indication that the law contemplates that such cases will be rare.

Stock Issued for Intangible Property. If stock is issued for intangible property prior to March 3, 1917, the amount which can be included in invested capital must not exceed:

1. The actual cash value of the property at the time paid in, or
2. The par value of the stock issued therefor, or
3. In the aggregate, 25% of the par value of the stock outstanding on March 3, 1917, whichever is the lower.

If stock is issued for intangible property after March 3, 1917, there can be included in the computation of invested capital an amount not exceeding:

1. The actual cash value of the property at the time paid in, or
2. The par value of the stock issued therefor, or
3. In the aggregate, 25% of the par value of the stock outstanding at the beginning of the taxable year, whichever is the lower.

In other words, when stock is issued for intangible property it is necessary to consider three things:

1. The value of the property received.
2. The par value of the stock issued.
3. The amount of 25% of the capital stock outstanding either on March 3, 1917, or at the beginning of the taxable year.

When these three amounts are determined, the lowest one will be taken in the computation of invested capital.

Stock Issued for Mixed Tangible and Intangible Property. In so far as possible, the tangible property received for stock should be separated from the intangible property and the amount of stock issued for each determined; in which case the amount to which such property can be considered in the determination of invested capital is determined as explained previously. If it is impossible to determine the amount of stock issued for the tangible property and the amount issued for intangible property, invested capital will be disregarded and the excess profits tax to be imposed on the corporation will be determined as explained below, for such cases where invested capital can not be determined.

Adjustment of Surplus. The surplus, as it appears on the books, may be subject to certain additions and certain deductions in order to arrive at the amount which is to be added to the capital stock to determine invested capital. If tangible property has been received for stock which has a value in excess of the par value of the stock, this excess may be added to the surplus. If tangible property is owned by the business, but does not appear on the books, such property under certain conditions may be put on the books and its value credited to Surplus. Such property may be shown as an asset and a credit to Surplus under the following restrictions:

1. It must be tangible property.
2. It must have a life extending substantially beyond the year in which the expenditure was made.
3. It must have been charged to current expense when purchased or later.
4. It must still be owned and in actual use.
5. It must have been acquired prior to March 1, 1913, or
6. If acquired after March 1, 1913, it must not have been previously claimed as a deduction on other income tax returns.

If large sums have been spent in creating good will, these amounts cannot be shown and credited to Surplus. If, however, good will has been purchased and then written off, it may be reconstructed on the books and credited to Surplus, providing it still can be shown to have a definite value.

If sufficient depreciation has not been allowed on assets, such depreciation will be charged against Surplus. If appreciation on fixed assets has been recorded after January 1, 1913 on the records and credited to Surplus, it must be deducted.

Final Adjustments. After the adjustments above outlined have been made, the Capital Stock account and the Surplus account will have had such deductions and additions made as will make them comply with the regulations and the law. As these two accounts were adjusted, certain asset accounts will have been adjusted accordingly. There may, however, be one more adjustment which must be made before the total of the Surplus and Capital account can be regarded as the invested capital of the business. There may be certain inadmissible assets owned by the business. If so, there must be deducted from the total of the Capital account and the Surplus account, a percentage equal to the percentage which the amount of the inadmissible assets held during the year is of the total of the assets.

Credits Allowed. The law says that for the purpose of determining the excess profits tax the following credits shall be allowed:

1. A specific exemption of $3,000.00.
2. An amount equal to 8% of the invested capital for the year.

Determination of the Tax. The law states that the excess profits tax shall be determined as follows:

1. 20% of the net income in excess of the excess profits credits and not in excess of 20% of the invested capital.
2. 40% of the amount of the net income in excess of 20% of the invested capital.

Computation of Invested Capital

(Invested Capital for any Period Equals Average Invested Capital for such Period).

INCLUDE—

1. Actual cash paid in for stock.
2. Actual cash value of tangible property paid in for stock (not to exceed par value of stock—excess value is paid-in surplus).
3. Paid-in or earned surplus and undivided profits earned prior to the taxable year.
4. Intangible property paid in for stock prior to 3/3/17 in an amount not exceeding either the—
   - (a) actual cash value at time paid in;
   - (b) par value of stock issued therefor;
   - (c) 25% of par value of total stock outstanding on 3/3/17.

   whichever is lower.
5. Intangible property paid in for stock on or after 3/3/17 in an amount not exceeding either the—
   - (a) actual cash value at time paid in;
   - (b) par value of stock issued therefor;
   - (c) 25% of par value of total stock at beginning of taxable year.

   whichever is lower.

Intangibles in 4 and 5 not to exceed 25% of par value of total stock outstanding at beginning of taxable year.

EXCLUDE—

Borrowed Capital.

DEDUCT—

Inadmissible Assets.—(Percentage to be deducted is equal to the percentage which the amount of the inadmissible assets held during the year is of the total of the assets.)

Computation of Taxes. It may be assumed that a corporation has invested capital of $100,000.00 and the net income for the current year is $30,000.00. The firm is entitled, as a credit, a specific exemption of $3,000.00 plus 8% of its invested capital or $8,000.00, or a total of $11,000.00. 20% of its invested capital is $20,000.00 and the difference between its credit of $11,000.00 and $20,000.00 is $9,000.00. The tax on this $9,000.00 is 20% or $1,800.00. Its income is $30,000.00 or $10,000.00 in excess of 20% of its invested capital, and this amount is subject to a tax of 40% or $4,000.00. Its total excess profits tax, therefore, is $1,800.00 plus $4,000.00 or $5,800.00.

The corporation is permitted a specific exemption of $2,000.00 plus the amount of the excess profits tax or $5,800.00, or a total exemption of $7,800.00. Its income is $30,000.00, therefore, the amount subject to the income tax is $30,000.00 minus $7,800.00, or $22,200.00. The income tax is at the rate of 10%, therefore, the income tax of the corporation is 10% of $22,200.00 or $2,220.00 and the total of its income tax and excess profits tax is $2,220.00, plus $5,800.00 or $8,020.00.

On the next page will be found a table showing the total income and excess profits taxes on net incomes ranging from \$5,000.00 to \$1,000,000.00 with the invested capital ranging from \$3,000.00 to \$10,000,000.00. To use the table in ascertaining the income and excess profits tax in the preceding problem, find the invested capital in the first column. This is \$100,000.00. Find the net income at the head of one of the columns following. This is \$30,000.00. Trace down the Net Income column and the total tax will be found opposite the amount of invested capital shown in column one. This is \$8,020.00, which is the same as that shown in the preceding calculations.

Where Invested Capital will be Ignored. The law provides that invested capital will be ignored in the following cases:

1. Where the Commissioner of Internal Revenue is unable to determine the invested capital by the method previously explained.
2. In the case of a foreign corporation.
3. Where mixed tangible and intangible property is paid in for stock or for stock and bonds, and the commissioner is unable to determine the amount issued for tangible and the amount issued for intangible property.
4. Where upon application by the corporation the commissioner finds that the regular operation of the law will work a great hardship on the corporation, owing to abnormal conditions. Comparison of the tax on the corporation asking relief with the tax imposed on other corporations of same nature will be made in order to judge the fairness of the tax.

In the foregoing cases, the commissioner will assess the tax without considering the invested capital of the corporation. The tax imposed will be an amount which bears the same ratio to the net income of this corporation less \$3,000.00 (the specific exemption allowed all corporations), as the tax imposed on representative firms, similarly situated, bears to their net income less \$3,000.00. To illustrate: The commissioner may decide that it is impossible to determine the invested capital of the X Corporation. By inspection of the returns of a number of firms doing the same kind of a business and similarly situated, he determines that the average excess profits tax which they pay is 25% of their average net income minus \$3,000.00. The net income of the X Corporation is \$28,000.00. Subtracting the \$3,000.00 specific exemption, there is \$25,000.00 subject to a tax of 25%; therefore, the excess profits tax of the X Corporation is \$6,250.00.

The law requires that in all cases where invested capital is ignored in the computation of the tax the commissioner must make a record and submit this record to Congress upon request.

1920 CORPORATION TAX TABLE

(Not Including Income Derived from Government Contracts)

Net Income	5,000	10,000	15,000	20,000	25,000	30,000	40,000	50,000	60,000	70,000	80,000	90,000	100,000	200,000	300,000	400,000	500,000	750,000	1,000,000
Invested Capital					TOTAL	EXCESS	PROFITS	TAX	AND	INCOME	TAX	COMBINED							
$ 3,000	660	2,060	3,460	4,860	7,160	9,460	14,060	18,660	23,260	27,860	32,460	37,060	41,660	87,660	133,660	179,660	225,660	340,660	455,660
5,000	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
7,500	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
10,000	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
15,000	588	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
20,000	444	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
25,000	300	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
30,000	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
35,000	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
40,000	"	1,844	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
45,000	"	1,592	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
50,000	"	1,340	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
60,000	"	1,196	3,136	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
70,000	"	1,052	2,632	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"
80,000	"	908	2,308	4,428	6,728	9,028	13,628	18,228	22,828	27,428	32,028	36,628	41,228	87,220	133,228	179,228	225,228	340,228	455,228
90,000	"	800	2,164	3,924	6,224	8,524	13,124	17,724	22,324	26,924	31,524	36,124	40,724	86,724	132,724	178,724	224,724	339,724	454,724
100,000	"	"	2,020	3,420	5,720	8,020	12,620	17,220	21,820	26,420	31,020	35,620	40,220	86,220	132,220	178,220	224,220	339,220	454,220
125,000	"	"	1,660	3,060	4,460	6,700	11,360	15,960	20,660	25,100	29,700	34,360	38,960	84,960	130,960	176,960	222,960	337,960	452,960
150,000	"	"	1,300	2,790	4,100	5,500	10,100	14,700	19,860	23,960	28,500	33,100	37,700	83,700	129,700	175,700	221,700	336,700	451,700
175,000	"	"	"	2,340	3,740	5,140	8,840	13,440	18,040	22,640	27,240	31,840	36,440	82,440	128,440	174,440	220,440	335,440	450,440
200,000	"	"	"	1,980	3,380	4,780	7,580	12,180	16,720	21,380	25,980	30,580	35,180	81,180	127,180	173,180	219,180	334,180	449,180
300,000	"	"	"	1,800	2,300	3,340	6,140	8,940	11,740	16,340	20,940	25,540	30,140	76,140	122,140	168,140	214,140	329,140	444,140
400,000	"	"	"	"	"	2,800	4,700	7,300	10,300	13,100	15,960	20,860	25,100	71,100	117,100	163,100	209,100	324,100	439,100
500,000	"	"	"	"	"	"	3,800	6,060	8,660	11,060	14,460	17,280	20,060	66,960	112,060	158,060	204,060	319,060	434,060
750,000	"	"	"	"	"	"	"	4,800	5,800	8,060	10,860	13,660	16,460	53,460	99,460	145,460	191,460	306,460	421,460
1,000,000	"	"	"	"	"	"	"	"	"	6,860	7,860	10,060	12,060	40,860	86,860	132,860	178,860	293,860	408,860
2,000,000	"	"	"	"	"	"	"	"	"	"	"	8,860	9,860	19,860	54,460	82,460	128,460	243,460	358,460
2,500,000	"	"	"	"	"	"	"	"	"	"	"	"	"	"	40,060	93,060	93,060	193,060	308,060
4,000,000	"	"	"	"	"	"	"	"	"	"	"	"	"	"	29,060	50,000	81,960	151,960	287,060
5,000,000	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	30,060	49,800	137,200	207,200
7,500,000	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	101,200	171,200
10,000,000	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	"	74,800	135,200

TO USE ABOVE TABLE: Find invested capital in first column, and net income at the head of one of the columns following. Trace down the Net Income column, and the tax will be found opposite the amount of invested capital as shown in first column.

ADDITIONAL PRACTICE IN COMPUTATION OF CORPORATION TAXES

Proposition A

Corporation A with an invested capital for 1920 of $300,000 has a net income of $150,000. Calculate the combined tax.

Solution

Original invested capital			$250,000
Capital added in 1920			50,000
Total invested capital for 1920			$300,000
Net income for 1920			150,000
First Bracket (Excess Profits Tax)			
20% on invested capital of $300,000		$ 60,000	
Deduct:			
8% on invested capital of $300,000	$24,000		
Specific exemption	3,000		
Total credits		27,000	
Amount taxable in first bracket		33,000	
20% of $33,000, or tax in first bracket			$6,600
Second Bracket (Excess Profits Tax)			
Net income for 1920		$150,000	
20% on invested capital of $300,000		60,000	
Amount taxable in second bracket		90,000	
40% of $90,000, or tax in second bracket			36,000
Total of excess profits tax			$42,600
Normal (Income) Tax			
Net income for 1920		$150,000	
Deduct:			
Excess profits tax	$42,600		
Specific exemption	2,000		
Total credits		44,600	
Amount subject to normal tax		$105,400	
10% of $105,400, or normal tax			10,540
Total tax to be paid by corporation A			$53,140

Proposition B

Corporation E has an invested capital for 1920 of $30,000 and a net income of $120,000. Calculate the total tax.

Solution

First Bracket (Excess Profits Tax)			
20% on invested capital of $30,000		$6,000	
Deduct:			
8% on invested capital of $30,000	$2,400		
Specific exemption	3,000		
Total credits		5,400	
Amount taxable in first bracket		$ 600	
20% of $600, or tax in first bracket			$120

Second Bracket (Excess Profits Tax)

Net income for 1920	$120,000	
20% on invested capital of $30,000	6,000	
Amount taxable in second bracket	$114,000	
40% of $114,000, or in tax second bracket		45,600
Total of excess profits tax		$45,720

The total excess profits tax shall not exceed 20% of that part of the net income represented by the difference between $3,000 and $20,000, or $17,000 plus 40% of the net income in excess of $20,000 which in this case is $100,000.

Computing the tax according to this provision, we have:

20% of $17,000	$ 3,400
40% of $100,000	40,000
Total	$43,400

Since this amount is less than the amount of the excess profits tax computed in the ordinary manner, we have as the excess profits tax........ $43,400

Normal (Income) Tax

Net income for 1920		$120,000	
Deduct:			
Excess profits tax	$43,400		
Specific exemption	2,000		
Total credits		45,400	
Amount subject to normal tax		$74,600	
10% of $74,600, or normal tax			7,460
Total tax to be paid by Corporation E			$50,860

INFORMATION AND PAYMENT AT SOURCE

Returns of Information. In any case where a return of information at the source is required, the obligation to file such return is imposed upon the person, partnership or corporation making the payment of income to another person, and the failure or delay in filing such return will involve penalties similar to those imposed for delinquency in filing the income tax and profits tax return. The date when returns of information must be filed is fixed by regulation of the commissioner as March 15, for annual returns and the 20th of each month for monthly returns. Such returns must be made on the calendar year basis and not for the fiscal year, and are filed at Washington by mail, and not with the local collector. The instructions printed on the blank form should be carefully observed.

Payments of $1,000 per Year. On or before March 15 in each year, without further notice or demand, there is due a return showing the amount of all payments made during the year of fixed and determinable gains, profits, and income (such as salaries, interest, or rent), amounting to $1,000.00 or more for the year, and a separate report showing the name and address of each recipient and the amount paid. (See form illustrated on next page). The requirement is not limited to periodical payments, but a single payment of $1,500.00 as fees to a lawyer or commissions to a broker would be included. Payments which are not purely income to the recipient, for example, payment for merchandise, storage, or telephone service, are not included. Certain other payments, although constituting fixed income of $1,000.00 or more, need not be reported, but are specifically excluded by the regulations as follows: Interest on obligations of the United States, states, or political subdivisions; compensation of officers and employes of a state or political subdivision, and other income which is excluded from the gross income; dividends of domestic corporations and payments by brokers to customers; payments made to corporations; payments made to employes for board and lodging in the course of their employment, or for expenses incurred in the business; premiums paid to insurance companies; annuities representing return of capital; payments of rent made to real estate agents (but the agent must report payments to the landlord amounting to $1,000.00 or more during the year); compensation paid to nonresident alien employes for services performed entirely in foreign countries; compensation paid by the United States Government; foreign interest and dividends; and income paid to nonresident alien individuals and corporations, subject to the withholding requirements.

Corporation Interest and Dividends. By general requirement of the regulations, every corporation must furnish information as to the interest paid upon its bonds or similar obligations, without regard to the amount of the particular payment. The corporation must forward to the Treasury Department the original ownership certificates which are required to be filled out and filed by the holders of the bonds when the coupons are presented for payment. The corporation may prepare the certificate in the case of interest payments on registered bonds. A return each month and an annual return must be filed. Information with respect to dividends and distributions to stockholders must be filed by every corporation which is particularly directed by the commissioner to do so or by all corporations when a general requirement shall be made by the commissioner. The corporation must then report the name and address of each stockholder, the number and class of shares owned by him, the date and amount of each dividend paid, and the time when the surplus was accumulated out of which each dividend was paid.

TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE
Form 1099
Revised January, 1921

INFORMATION AT THE SOURCE, 1920

NAMES MUST BE PRINTED OR WRITTEN PLAINLY

Report of Income of $1,000 or more paid during the Calendar Year 1920

SALARIES, WAGES, RENT, INTEREST, OR OTHER FIXED OR DETERMINABLE GAINS, PROFITS, AND INCOME
(ALSO DISTRIBUTIONS TO BENEFICIARIES OF ESTATES AND MEMBERS OF PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS)

BY WHOM PAID	TO WHOM PAID
NAME........................	NAME........................
STREET........................	STREET........................
CITY..................STATE..............	CITY..................STATE..............

c2—8573

INSTRUCTIONS

One of these forms must be filled in for each person, partnership, or fiduciary to whom income, as described on this form, was paid during the calendar year 1920. The name and business address of the person or organization making the payments should be entered under the heading "By whom paid" and the name and home address (if an individual) or business address (if an organization) of the one to whom the income was paid should be entered under the heading "To whom paid."

These forms must be forwarded with return Form 1096 so as to reach the Commissioner of Internal Revenue, Sorting Section, Washington, D. C., on or before March 15, 1921.

Do not report on this form dividends on stock, interest on bonds of domestic or foreign corporations, or interest on bonds and other obligations of the United States or foreign countries. For further instructions, see Form 1096.*

If payee is an individual, is he married? ....

KIND OF INCOME PAID	AMOUNT		
Salaries, wages, fees, commissions, etc. ..	$......	....	......
Rent..............................	$......	....	......
Interest on notes, mortgages, etc........	$......	....	......
Premiums and annuities................	$......	....	......
Fiduciary distribution................	$......	....	......
Partnership or personal service corporation profits, earnings, etc............	$......	....	......

*Space will not permit illustrating Form 1096. This form is known as an "Annual Information Return" and contains a summary of payments of income, etc., required to be reported under the Revenue Act of 1918 for the current calendar year. These returns are not permitted on a fiscal year basis. Both of these forms must be filled in by every individual, corporation, partnership, personal service corporation, association, or insurance company (including lessees or mortgagors of real or personal property, trustees, executors, administrators, receivers, employers, and all officers and employes of the United States who paid interest, rent, salaries, etc., to another individual, partnership, personal service corporation, or fiduciary during the calendar year 1920.

Brokers. Brokers may be required, either by special direction or by general regulations applying to all brokers, to make returns showing the names of all customers, details as to the profits and losses of each, and such other information as the regulations may require.

Foreign Interest and Dividends. Information returns are required of every person in the business of collecting coupons, checks, or bills of exchange not payable in the United States, in payment of interest on bonds of foreign countries and foreign corporations, or dividends on stock of foreign corporations and all such payments, no matter how small the amount, must be reported. Persons undertaking the collection of such foreign items as a matter of business or profit must be licensed by the Treasury Department. Where interest on bonds of foreign countries or of foreign corporations, or dividends upon the stock of a foreign corporation is payable in this country by a resident fiscal agent or by check drawn upon a bank in this country, information returns are likewise required. As to bond interest, the paying agent in this country, or if no such agent, then the first bank or collecting agent, is required to furnish the information. As to dividends, the first bank or collecting agent, accepting the item for collection is the source of information. A monthly return and an annual return are required. Where a foreign corporation has a fiscal agent in this country and issues bonds which contain a tax-free covenant clause, payment at the source and the return of such payment are required as explained later.

Payment at the Source. In order to assist in the collection of the tax, payment is required by the person paying the income, rather than the one receiving it, in the case of interest on tax-free bonds and payments to nonresident alien and foreign corporations of fixed and determinable annual or periodical income (but not including interest on tax-free bonds or dividends of domestic corporations) without regard to the amount of the payment. Upon such income, the tax payable at the source is 8% upon the income of nonresident alien individuals, and 10% for foreign corporations. On or before March 1 of each calendar year, with no provision of fiscal years, every person required to pay at the source a tax upon any income other than bond interest, is required to file with the local collector an annual return accompanied by a separate report for each person to whom such income was paid. The amount of tax must be paid on or before June 15 of each year. The law permits the amount so paid to be deducted and withheld from the payment made to the recipient, except where there is a contractual obligation to the contrary, as with tax-free bonds. Where a nonresident alien claims exemption from withholding upon salary or wages, the employer must preserve the affidavit and file it with the next annual withholding return. The employer is not excused from withholding where

the affidavit contains any statement which he knows to be untrue or if it shows on its face that the alien is not entitled to the credit claimed or that the credit has been exhausted.

Interest on Tax-Free Bonds. Whenever bonds, mortgages, or similar obligations of a corporation contain a contract or provision by which the corporation agrees to pay the interest upon such obligation without deduction for any tax which the corporation may be required or permitted to pay thereon or to retain therefrom under the Federal Income Tax Law, or by which the corporation agrees to pay, on behalf of the owner of the bonds, any portion of any federal income tax imposed upon the interest, or to reimburse the owner therefor, the corporation is required to pay to the government a tax of 2% of the interest. As there are many different forms of "tax-free covenants," it must be determined in each case whether the language used covers the federal income tax. These provisions apply only to long term or funded obligations which may be classed as securities, and not to promissory notes, scrip, or ordinary commercial paper. Securities issued by syndicates, partnerships, or individuals, subject to tax-free covenants, are not included, although they may in all other respects resemble the obligations of corporations, as to which payment at the source is required. The tax must be paid without regard to the amount of the particular payments, but only when the interest is paid to an individual or partnership (or foreign corporation) and not when paid to a domestic corporation. The tax need not be paid if the owner files a notice before February 1 claiming exemption or credits covering the interest received during the previous year. This claim is usually made by means of the ownership certificate filed at the time the interest is collected. The corporation, which is required to pay the tax at the source upon the interest upon its tax-free bonds, is required to make a monthly return on or before the 20th day of the month following that in which the interest was paid. On or before March 1 of each year an annual return must be filed with the collector. The tax must be paid on or before June 15.

Certificates of Ownership. Any person making payments of income for which he is required to pay a tax at the source, or to give information at the source, is entitled to demand the necessary information from the recipient of the income, and certificates in appropriate form may be secured for this purpose from the collector. Such certificates must be furnished whenever there is presented for payment interest coupons from bonds or other obligations issued by domestic or foreign corporation, whether or not containing a tax-free covenant. Form 1000 is to be used when the interest is subject to payment of tax at the source; when not so subject, Form 1001, or Form 1001A for foreign items, is to be used. Whenever actual ownership is not known, the tax must be paid at the source just as if the owner was a nonresident alien.

INCOME TAX QUESTIONS AND PROBLEMS

1. What is invested capital under the new Revenue Act?
C. P. A. Ex.

2. Can the value of property conveyed to a corporation by a stockholder as a gift be treated as paid-in surplus so as to become invested capital? Give reasons. C. P. A. Ex.

3. (a) Will invested capital be increased by a reappraisal of capital assets?

(b) Will such reappraisal operate to increase taxable income before such assets are sold? C. P. A. Ex.

4. A corporation began business January 1, 1920, with assets consisting of patents for which they paid $100,000.00 in cash and capital stock outstanding $100,000.00.

In computing the income taxes at the end of the year, what would be the invested capital? C. P. A. Ex.

5. A corporation owned on January 1, 1919, assets including Accounts Receivable and Cash, $10,000.00; Fourth Liberty Bonds, $10,000.00; stocks in other corporations, $10,000.00; Pennsylvania Railway bonds, $10,000.00; plant at cost, $10,000.00; State of Virginia bonds, $10,000.00.

The liabilities were, capital stock paid in $30,000.00, and surplus paid in, $20,000.00, and profits earned, $10,000.00.

Submit a statement showing the invested capital for purposes of computing the income and profits taxes for 1919.
C. P. A. Ex.

6. The A. B. C. company agreed to pay its general manager a bonus of 10% of its net profits for the year 1920, after deducting federal income and profits taxes, the bonus being a deductible expense in determining net taxable income. After the books had been audited, it was found that the net profits before deducting federal income and profits taxes, and before deducting bonus, amounted to $470,000.00, and that the invested capital for federal tax purposes for the year 1920 was $840,000.00. Calculate the amount of the bonus and federal income and profits taxes, proving your answer by showing that the bonus amounts to exactly 10% of the profits after deducting federal income and profits taxes. The entire bonus comes out of the 40% bracket.

Tax information:

Excess profits taxes exemption:

$3,000.00 and 8% of the invested capital.

Income tax exemption:

$2,000.00 and amount of excess profits taxes.

Rates:

Excess profits taxes:

20% of the net profits in excess of the exemption and not in excess of 20% of the invested capital.
40% of the balance of profits.

Income tax:

8% of profit less exemption.

Tax before bonus, $166,571.20 Inst. Ex.

7. The books of a Retail Installment Furniture Dealer, covering the two years, 1919 and 1920, show the following:

ASSETS:

	Dec. 31, 1918	Dec. 31, 1919	Dec. 31, 1920
Cash	$ 8,000	$15,000	$ 20,000
Installment accounts	25,000	60,000	120,000
Inventory of Mdse.	15,000	35,000	50,000
	$48,000	$110,000	$190,000

LIABILITIES:

Accounts Payable	$ 5,000	$10,000	$25,000
Notes Payable	5,000	35,000	50,000
Capital Stock	30,000	30,000	30,000
Surplus	8,000	35,000	85,000
	$48,000	$110,000	$190,000

PROFIT AND LOSS ACCOUNT:

	Year ending Dec. 31, 1919	Year ending Dec. 31, 1920
Salaries to officers	$ 2,000	$ 5,000
Cost of merchandise sold	18,000	34,000
Salesmen's commissions	5,000	8,000
Rents	1,000	1,000
Miscellaneous expense	1,000	2,000
Profits earned	27,000	50,000
	$54,000	$100,000

The collections in 1919 amounted to $19,000.00 of which $10,000 was 1918 accounts, and the collections in 1920 amounted to $40,000, of which $15,000 was 1918 accounts. The returns were made up and the income returned according to the books and you are asked to redetermine the tax, under Art. 42 of Regulations 45.

(a) Recast and prepare Balance Sheet for Dec. 31, 1919, and Dec. 31, 1920.

(b) Prepare Profit and Loss statement for the two years, 1919 and 1920, showing taxable income.

(c) Prepare journal entries that will change the books in accordance with Art. 42.

(d) Submit a statement showing invested capital at Dec. 31, 1919, and Dec. 31, 1920. C. P. A. Ex.

Appendix

SUPPLEMENTARY PROBLEMS

The problems following are given for supplementary and review work. They are graded so as to naturally follow the discussion in the text. If desired, one problem might be required as supplementary practice work following each chapter of the text. The problems are selected from the C. P. A. and Institute examinations, hence are representative of the problems to be encountered in future examinations.

Problem One

X, Y, and Z enter into the real estate business equal partners. X and Y being experienced, but without money or property to invest, arrange with Z to loan the firm $27,000.00 at 6% which is invested in acreage. It is agreed that the loan is to be repaid out of the profits of the business on condition that two-thirds of the annual profits are to be set aside in cash for that purpose and no profits are to be withdrawn until the note with interest is fully paid. Assuming that the profits during the first year were just sufficient to warrant a distribution of profits leaving the investment undisturbed, and that there were no partial payments—

Prepare journal entries giving effect to the above considerations, and Trial Balances showing the condition of the books at close as relating to the affected accounts:

(a) Before payment of the note and interest.

(b) After payment of note, interest and dividends.

C. P. A. Ex.

Problem Two

A, B, C and D have decided to dissolve partnership. To that end they have liquidated all their liabilities, and at the date of the first division of cash among the partners the conditions are as follows:

Partners	Capitals	Loans	Profit and Loss Ratio
A...........	$22,000.00	$ 7,000.00	40%
B...........	19,000.00	6,000.00	30%
C...........	12,000.00	14,000.00	20%
D...........	7,000.00	13,000.00	10%
Totals.......	$60,000.00	$40,000.00	100%

Cash available for distribution..........	$ 20,000.00
Other assets not yet realized (of doubtful value).........................	80,000.00
	$100,000.00

State which partners should participate in the distribution of the $20,000.00; how much cash each should receive; whether the payments should be applied against the capital accounts or the loan accounts. Explain the procedure of determining the distribution. Assume that none of the partners has any private property. Inst. Ex.

Problem Three

X, Y, and Z, foundrymen, unable to meet their obligations' suspend payment January 1, 1921, and appoint a trustee to realize and liquidate for the benefit of their creditors. The books showed the following assets and liabilities:

Balance Sheet

ASSETS		LIABILITIES	
Land and Building	$125,000.00	Mortgage on foundry premises	$100,000.00
Machinery and Tools	75,000.00	Notes Payable	135,000.00
Furniture and Fixtures	10,000.00	Accounts Payable	105,040.00
Materials and Supplies	95,000.00	Int. Accrued on Mtge.	1,220.00
Notes Receivable	15,000.00	Taxes Accrued	840.00
Accounts Receivable	115,000.00	Capital	93,350.00
Cash	450.00		
	$435,450.00		$435,450.00

The trustee's cash receipts and disbursements during the year 1921 were as follows:

Cash Receipts and Disbursements

RECEIPTS		DISBURSEMENTS	
Notes Rec. (outstanding, Jan. 1, 1921)	$ 15,000.00	Notes Payable	$ 25,000.00
Accts. Rec. (outstanding, Jan. 1, 1921)	106,500.00	Accounts Payable	35,000.00
Cash Sales	5,435.00	Interest on Mtge. 1 year at 5%	5,000.00
Notes Rec. (cont. during 1921)	13,500.00	Taxes for year 1920	810.00
Accts. Rec. (cont. during 1921)	212,000.00	Purchase of material and supplies	98,000.00
		Labor	135,030.00
		General Expenses	45,020.00
		Interest on Bills payable to Sept. 30, 1921, at 5%	2,800.00
Total receipts	$352,435.00	Total payments	$346,660.00

Other transactions were as follows:

Sales on credit		$335,000.00
Bad Debts written off accounts prior to January 1, 1921	$8,000.00	
Bad Debts written off accounts subsequent to January 1, 1921	2,000.00	10,000.00
Discounts and allowances to Customers' accounts prior to January 1, 1921	500.00	800.00

Discounts and allowances to Customers' accounts subsequent to January 1, 1921	$300.00	$ 800.00
Notes received from customers		20,000.00
Notes given to Creditors ($110,000.00 being renewals)		180,000.00
Inventory of Materials, December 31, 1921		92,000.00

At the end of the year, the business was returned to the owners. Prepare Realization and Liquidation Statement, and Balance Sheet. C. P. A. Ex.

Problem Four

A firm desires to transfer its property to a corporation duly organized to carry on the business. The net assets of the firm consist of the following:

Land and Buildings	$150,000.00
Inventory	100,000.00
Accounts Receivable	150,000.00
Good Will and Patents	100,000.00
Cash	50,000.00
	$550,000.00

It is proposed to issue in full payment therefor, bonds, preferred stock, and common stock aggregating the sum of $500,000.00, of which each partner is to receive his proportionate share according to his interest in the firm, viz: Jones 60%; Brown, 25% and Smith 15%.

(a) Prepare opening entries for the new company.

(b) Prepare a statement of assets and liabilities.

(c) State what amount of each class of securities each of the partners should receive. C. P. A. Ex.

Problem Five

The Michigan Manufacturing Company was incorporated under the laws of the State of Michigan, February 1, 1921, with a capital stock of $10,000,000.00, consisting of $4,500,000.00 (45,000 shares of $100.00 each) preferred 7% non-cumulative stock, and $5,500,000.00 (55,000 shares of $100.00 each) of common stock. On the same date $2,000.00 of the common stock was subscribed for at par as follows:

A. Van Oss	2 shares	$200
T. L. W. Porte	4 shares	400
Wiley T. Lyon	4 shares	400
David Smith	3 shares	300
William Leslie	7 shares	700

On February 4, 1921, these subscribers paid into the company the amount of their subscriptions, and stock was issued to them. February 15, the balance of the authorized capital stock of the company, both preferred and common, was issued by resolution of the board of directors to A. A. Keiser, for and in consideration of $750,000.00 in cash and twelve (12) manufacturing plants. An inventory of the property purchased, made by authorized representatives of the company, resulted in the following appraised valuations on the various plants and the stocks on hand:

Factory	Material and Supplies	Mdse.	Real Estate	Bldgs.	Machinery
A......	$430,000	$95,000	$195,000	$20,000	$98,000
B......	211,000	44,000	130,000	10,000	84,000
C......	495,000	38,500	475,000	11,000	62,000
D......	304,000	15,000	924,000	13,000	48,000
E......	171,000	32,750	184,000	14,500	89,000
F......	86,500	81,000	60,000	17,750	26,000
G......	47,250	44,000	30,000	32,500	34,000
H......	98,000	35,750	20,000	14,600	62,000
I.......	101,250	11,000	10,000	17,200	11,000
J.......	37,000	13,000	11,000	19,200	35,000
K......	346,000	49,000	14,000	75,000	71,000
L......	121,000	67,000	37,000	34,750	44,000
Totals..	$2,448,000	$526,000	$2,090,000	$279,500	$664,000

Open the accounts of the company so that the result of the operation of each factory will be known at the end of the company's fiscal year. The books of the company are not to show the appraised valuation placed on the real estate, buildings, tools, machinery, etc., by factories, but in one amount only; and it is desired that the account include any expenditure incurred by the company for good will, etc.

Make opening entries in cash book, journal, and ledger, covering in full the above transactions. C. P. A. Ex.

Problem Five—A

The Detroit United Railway Company, with an authorized capital stock of $1,000,000.00 consisting of 5,000 shares each of preferred and common stock at the par value of $100.00, had on January 1, 1921, assets and liabilities as follows:

ASSETS

Real Estate and Building........................	$ 200,000.00
Power Plant and Machinery.....................	250,000.00
Aerial Construction...............................	200,000.00
Surface Construction.............................	200,000.00
Underground Construction.....................	150,000.00
Rolling Stock......................................	300,000.00
Accounts Receivable............................	10,000.00
Cash..	5,000.00
	$1,315,000.00

LIABILITIES

Preferred Stock	$ 450,000.00
Common Stock	400,000.00
First Mortage Bond, 5%	350,000.00
Accounts Payable	5,000.00
Surplus	110,000.00
	$1,315,000.00

The Pontiac Electric Company, with an authorized capital stock of $500,000.00, had on the same day, assets and liabilities as follows:

ASSETS

Real Estate	$300,000.00
Power Plant and Machinery	150,000.00
Aerial Construction	125,000.00
Underground Construction	100,000.00
Sundry Assets	15,000.00
Profit and Loss	10,000.00
	$700,000.00

LIABILITIES

Capital Stock	$500,000.00
Mortgage, 6%	100,000.00
Accounts Payable	100,000.00
	$700,000.00

The Detroit United Railway Company purchased securities of the Pontiac Electric Company in quanities and at prices as follows:

$400,000.00 of the capital stock at $125.00, payable in cash.

$50,000.00 of the capital stock at $130.00, payable with $30,000.00 of the preferred stock of the Detroit United Railway Company at $150.00 and cash to balance.

$100,000.00 of the bonds at $115.00, payable in the unissued common stock of the Detroit United Railway Company, at $93.00 and cash to balance.

$10,000.00 of the cash payable for the stock purchased to be passed to credit of Profit and Loss account of the Pontiac Electric Company by the vendors to cancel the charge of like amount to said account.

To provide funds to meet the above obligations and also to retire its 5% Mortgage Bonds at $105.00, the Detroit United Railway Company issued $1,000,000.00 of 4% Bonds and sold the entire amount for cash at 95%.

Assuming that the dividend of the Pontiac Electric Company declared during the year 1921 amounted to $25,000.00, and the profit of the Detroit United Railway Company from operating exclusive of interest on its bonded debt amounted to $100,000.00, to what extent has the profit and loss of the Detroit United Railway Company been affected, during the year, by reason of its acquisition of the securities of the Pontiac Electric Company and of the redemption of its own 5% Bonds? Show also the condition of accounts of the Detroit United Railway Company at the end of the year. C. P. A. Ex.

Problem Six

The following is a Trial Balance of The Western Telephone Company as of December 31, 1920:

	Dr.	Cr.
Cash	$ 300.00	
Exchange Bank, Acton	3,877.40	
Central Bank, Burton	793.20	
J and A Bank, Castleton	727.40	
Accounts Receivable, Acton	8,695.60	
Accounts Receivable, Burton	7,589.80	
Accounts Receivable, Castleton	5,328.00	
Notes Receivable	258.50	
Accounts Payable		$ 3,976.00
Notes Payable		53,200.00
Interest Payable		1,052.00
Material and Supplies	20,146.50	
Furniture and Fixtures	12,253.50	
Real Estate	45,000.00	
Switchboards and booths	23,115.40	
Poles	209,770.50	
Wire lines	131,269.70	
Telephones	127,515.90	
Capital Stock		350,000.00
Surplus		171,572.30
Tolls paid to foreign companies	4,791.20	
Rental allowances	5,942.00	
Rentals, Acton Exchange		44,077.50
Rental allowances	3,984.00	
Rentals, Burton Exchange		26,425.30
Rentals, Castleton Exchange		20,244.90
Tolls, Acton Exchange		8,202.50
Tolls, Burton Exchange		4,452.50
Tolls, Castleton Exchange		2,800.70
Pay station tolls, Acton		637.00
Pay station tolls, Burton		727.50
Pay station tolls, Castleton		988.60
Supply sales, Acton		126.80
Supply sales, Burton		57.50
Refunds, Acton	52.50	
Salaries, central office	3,000.00	
General expense	13,121.30	
Insurance	745.90	
Operators' wages, Acton	6,935.00	
Operators' wages, Burton	4,890.00	
Operators' wages, Castleton	5,700.00	
Repairs of wire plant	14,022.00	
Repairs of equipment	14,435.30	
Traffic Expense	485.00	
Profit and Loss		204.50
Dividends paid	14,000.00	
	$688,745.60	$688,745.60

Allowance for depreciation as follows:

Furniture and Fixtures .... 10% per year

Plant and Equipment .... 5% per year

Inventories, July 1, 1920:

Material and Supplies $184.30

Required: Statement showing results of operation for six months ended December 31, 1920.

Balance Sheet as at January 1, 1921.

C. P. A. Ex.

Problem Seven

A proposed merger of four manufacturing companies involves combined assets and liabilities as follows:

Cash in Bank	$ 14,479.00
Reserve for Bad Debts	34,050.00
Good Will and Patents	293,132.00
Reserve for Depreciation of Good Will and Patents	159,849.00
Reserved for Corporation Taxes	5,000.00
Dividends Accrued on Preferred Stock	875.00
Pay Roll Accrued	44,893.00
Buildings	332,637.00
Bills Receivable—Customers	2,333.00
Invested in Notes of Other Corporations	190,129.00
Accrued Interest on Notes of Other Corporations	2,000.00
Accounts Receivable	345,478.00
Inventories	1,471,201.00
Sundry Debtors	29,191.00
Reserve for Depreciation of Plant	346,144.00
Securities Owned	14,552.00
Reserved for Loss on Securities Owned	1,455.00
Real Estate	46,075.00
Deferred Charges to Future Operation	9,350.00
Accounts Payable	176,888.00
Machinery and Equipment	862,920.00
Unclaimed Pay	728.00
Furniture and Fixtures	27,762.00

The Consolidated Tool Company is incorporated under the Michigan laws to take over the business of the four companies. Authorized capital stock, preferred, $500,000.00; common, $1,000,000.00; par value of shares $100.00 each. It is arranged that the minimum number of shareholders subscribe and pay in cash one share each of common to effect the incorporation, and that the remaining shares be subscribed and issued to the Peninsular Trust Company to be divided under agreement among the stockholders of the old companies.

Coincidently an issue of 5% First Mortgage Bonds is made amounting to $1,500,000.00 of which $125,000.00 is retained in the Treasury. Reorganization expenses paid out of the funds of the company amount to $10,250.00.

(1) You are asked to make the opening journal entries for the Consolidated Tool Company.

(2) Prepare Consolidated Balance Sheet exhibiting the financial condition of the Consolidated Tool Company.

C. P. A. Ex.

Problem Eight

On December 31, 1921, a Trial Balance taken from the books of Jones & Brown, manufactures, shows the following:

John Jones, Capital Account........		$12,500.00
James Brown, Capital Account.....		10,000.00
Sales............................		25,000.00
Stock, January 1, 1921............	$ 6,250.00	
Purchases.........................	20,000.00	
Bills Payable.....................		7,500.00
Debtors...........................	10,500.00	
Creditors.........................		5,000.00
Carriage and cartage..............	1,250.00	
Repairs and maintenance...........	250.00	
Coal..............................	175.00	
Gas and water.....................	50.00	
Oil, grease and waste.............	225.00	
Taxes and insurance...............	175.00	
Bank interest.....................	50.00	
Discounts and allowances..........	500.00	
Bad debts.........................	150.00	
Buildings, machinery and plant.....	10,000.00	
Horses, carts, etc................	1,000.00	
Tools and furniture...............	375.00	
Wages.............................	2,500.00	
Salaries..........................	1,000.00	
Incidental expenses...............	250.00	
Cash in bank......................	2,000.00	
Cash on hand......................	50.00	
Bills Receivable..................	2,500.00	
Partners' salaries................	750.00	
	$60,000.00	$60,000.00

Stock, December 31, 1921, $7,500.00. Depreciation $500.00. Accrued incidental expenses, $125.00. Loss on debtors' balances, $100.00. Discount on debtors' balances 5%. Net profit is divided between partners in proportion to their capital, January 1, 1921. Prepare statement showing Cost of Sales, Profit and Loss statement and a Balance Sheet. C. P. A. Ex.

Problem Nine

(a) A soap company has adopted the policy of giving away premiums in connection with its sales, by means of coupons which are to be redeemed in quantities provided as per a printed list. How should these premiums be treated in preparing a Balance Sheet, Profit and Loss statement, etc?

(b) A milk company sells to its customers strips of tickets which are good in payment of the milk delivered to them. These tickets are paid for in advance by the customers. What accounts would you expect to find on the books and how should the entries be handled showing the transactions of the sales of tickets and the deliveries of milk? C. P. A. Ex.

Problem Ten

Lay up a complete administrative chart for a large manufacturing concern to show the different departments and departmental heads from the board of directors down, so as to place responsibility, indicate control and to show to whom reports should be made. C. P. A. Ex.

Problem Eleven

The following problem is based upon the estimate cost system. No factory ledger is used, all accounts being kept on the general ledger. The business is the making of men's clothes, and two principal materials are used, fine woolens and plain woolens, of which stock records are kept. Stock records are also kept for finished goods.

(a) The following styles of clothing are made, and they are estimated to cost:

	Style 801	Style 802	Style 803
Materials used	$12.50	$ 8.00	$ 4.00
Supplies (linings, buttons, etc.)	3.00	2.50	2.00
Labor	9.00	6.00	4.50
Factory expenses, 60%	5.40	3.60	2.70
	$29.90	$20.10	$13.20

Note that the estimated costs are subdivided into four sections and that the accounts must be kept to record the corresponding subdivisions of operating costs.

(b) The company starts with the following:

	Dr.	Cr.
Machinery and Equipment	$10,000.00	
Cash	40,000.00	
Capital Sotck		$50,000.00

(c) The purchases for the first month according to voucher record are:

Materials, fine woolens, 2,000 yds., at $3.00	$6,000.00
Materials, plain woolens, 3,000 yds., at $1.50	4,500.00
Rent of factory	500.00
Lining, buttons and thread, etc	3,400.00
Salesmen's commissions paid	700.00
Office expenses	120.00
Repairs to machines and equipment	350.00
Electric power	440.00
Oil, waste and other factory supplies	225.00
	$16,235.00

(d) The pay rolls are summarized as follows:

Foreman and timekeepers	$ 250.00
Tailors, cutters, etc. (direct labor)	4,600.00
Office and salesmen's salaries	750.00
Inspectors and other indirect factory wages	435.00
	$6,035.00

(e) Depreciation on equipment is calculated at 1% per month.

(f) The cutting room foreman reports having taken from stock and cut for use on garments in progress, 1,400 yds. fine woolens and 2,200 yds. plain woolens.

(g) The tailoring foreman reports the following garments finished and placed in stock:

Style No. 801	200 pieces
Style No. 802	300 pieces
Style No. 803	200 pieces

(h) The sales record is as follows:

Invoice No. 1,	Style No. 801,	100 pieces	$ 4,000.00
	Style No. 803,	100 pieces	2,000.00
Invoice No. 2,	Style No. 801,	50 pieces	2,050.00
Invoice No. 3,	Style No. 802,	100 pieces	3,000.00
Invoice No. 4,	Style No. 802,	100 pieces	2,800.00
	Style No. 803,	25 pieces	450.00
			$14,300.00

(i) Hint: make entry for cost of sales.

(j) Received cash from customers, $9,000.00.

(k) Paid out cash for wages, $6,035.00, and vouchers, $7,650.00.

(l) Inventories at end of month. (In addition to stocks of raw materials and finished goods as shown by stock records.)

Supplies, $1,000.00

Unfinished goods:

Style No. 801, 50 pieces. All material cut. All supplies provided. Labor half completed.

Style No. 802, 100 pieces. All material cut. Half of supplies provided. Half of labor finished.

(m) Prepare Balance Sheet and Profit and Loss statement for the month. Add or deduct from Cost of Sales, when preparing Profit and Loss statement, the unabsorbed labor, expenses, etc. Show how balances of raw material and finished goods are made up. Inst. Ex.

Problem Twelve

In June, 1915, A purchased a dwelling for the sum of $15,000.00. He resided in the dwelling until December 1, 1920, when he sold the property at a loss. During 1920, he paid out for taxes $186.00, for insurance $60.00, for repairs $130.00, for interest on mortgage $250.00. His net loss on the sale was $1,200.00.

In preparing A's Income Tax return for 1920, how would you treat the items specified? Inst. Ex.

Problem Thirteen

You are asked by an individual (married) to prepare a form of return for making application for deductions as provided by the Federal Income Tax Law.

You find his income and expenditures for year ending December 31, 1921, to be as follows:

	Expenses	Income
Salary		$10,000.00
Interest on Real Estate Mortgage		960.00
Dividends U. S. Steel Corporation		1,200.00
Rentals		2,200.00
Interest, Bonds U. S. Steel Corp'n		1,000.00
Interest, U. S. Government 3s		2,400.00
Interest, City of Detroit 4s		4,000.00
Gain Sale of Real Estate		500.00
Inheritance, Stock Penna. Ry. Co., Par		25,000.00
Life Insurance Benefit		5,000.00
Special fee as commissioner of estate		500.00
Allowance to wife	$2,000.00	
Household expenses, including rent	9,620.00	
Fire Loss, Tenement property (net)	650.00	
Interest Bank Loans	5,400.00	
Life Insurance Premiums	600.00	
Taxes, City, State and County	220.00	
Automobile	2,500.00	
Charitable donations	400.00	
Losses Stock Exchange operations	4,400.00	
Losses Bad Debts	1,750.00	
Taxes—Special Paving	50.00	
Depreciation of Buildings	1,000.00	

Prepare in brief statement form your understanding of the effect of the law in relation to this individual's affairs.

C. P. A. Ex

Problem Fourteen

From the following information, taken from a single entry set of books, you are required to construct a Trial Balance and prepare an accountant's working sheet, a Balance Sheet with supporting schedules, a Profit and Loss statement with supporting schedules, and an Income Tax return with the necessary supporting schedules, etc., for the calendar year 1920:

VALLEY HARDWARE COMPANY

Balance Sheet—December 31, 1919

ASSETS

Current:			
Cash		$10,742.06	
Accounts Receivable	$11,480.41		
Less Res. for Doubtful Accts.	500.00	10,980.41	
Notes Receivable		202.45	
Merchandise Inventory		17,108.58	$39,033.50
Deferred Charges:			
Prepaid Insurance Premiums (Apt. House)			318.00
Outside Investments:			
Real Estate Contracts			
Adams	$ 600.00		
Baker	1,124.00	$ 1,724.00	
Land			
Apartment Property	$23,500.00		
Garage Property	7,500.00		
2 Lots Sunny Addition	40.00		
Equity in Timber Property	2,000.00	33,040.00	
Buildings			
Apartment House (Brick)	$41,500.00		
Less Res. for Depr.	3,245.00	38,255.00	
Garage (Cement)	$14,500.00		
Less Res. for Depr.	1,435.00	13,065.00	
Stocks and Bonds		5,050.00	91,134.00
Fixed:			
Land			
Store Property	$ 1,500.00		
Store Warehouse Property	1,425.00		
Track Warehouse Property	75.00	$ 3,000.00	
Buildings			
Store Bldg. (Wood)	$ 5,000.00		
Less Res. for Depr.	4,550.00	450.00	
Store Warehouse	$ 500.00		
Less Res. for Depr.	365.00	135.00	
Track Warehouse	$ 100.00		
Less Res. for Depr.	53.00	47.00	
Store Fixtures (Inventory value)		1,006.50	
Office Equipment (Inventory value)		185.40	
Shop Tools and Equipment (Inventory value)		320.68	5,144.58
Total Assets			$135,630.08

LIABILITIES

Current:			
Accounts Payable			
Trade Creditors	$ 1,643.13		
Expense Bills	939.43	$ 2,582.56	
Notes Payable		1,400.00	
Accrued Taxes		2,514.22	
Accrued Indust. Ins. (Est'd)		20.00	
Accrued Interest		39.00	
		$ 6,555.78	

Fixed:		
Mortgage Payable	$ 5,000.00	
Total Liabilities		11,555.78
NET WORTH		$124,074.30
Represented by		
J. Valley Capital December 31, 1918		$124,074.30

OTHER DATA

Cash on hand December 31, 1920		$ 23,019.54
Accounts Rec. December 31, 1920		20,927.85
Notes Rec. December 31, 1920		6,178.20
Mdse. Inv. December 31, 1920		24,040.37
Real Estate Contracts:		
Adams	$ 500.00	
Baker	1,068.83	
Fry	1,375.00	2,943.83
Factory Land Purchased in 1920 for		1,900.00
Shop Tools and Equipment valued as on Dec. 31, 1919		
Liberty Bonds on hand Dec. 31, 1920 (No stock)		3,000.00
Write off 3% depreciation on all buildings		
Write off 10% depreciation on Store Fixtures and Office Equipment		
Launch sold in 1920 for $600 which did not appear in Balance Sheet as of December 31, 1919		
Unexpired Insurance (Apartment House)		60.00
Accounts Payable December 31, 1920:		
Trade Creditors		9,294.33
Expense Bills (Business)		651.95
Wages		312.12
Industrial Insurance (Business)		30.00
Interest (Business)		150.00
Notes Payable December 31, 1920		6,147.90
Mortgage Payable December 31, 1920		5,000.00
Accrued Taxes, December 31, 1920		2,933.25
Net Sales for 1920		191,805.80
Apartment House Income, 1920 (Collected)		12,029.45
Garage Income, 1920 (Collected)		1,620.00
Other Rental Income, 1920 (Collected)		132.00
Interest Income (Notes), 1920 (Collected)		333.11
Profit from sale of Bank Stock, 1920		300.00
Fees received as Director of Bank		80.00
Income from joint venture		52.59
Interest Income (Bonds)		112.88
Proprietor's Personal Drawings, 1920		4,274.52
Bad Debts written off in 1920		668.91
Set up Reserve for Doubtful Accounts for 1920		668.91
Cash paid as follows in 1920:		
Income Tax for 1919		2,643.32
To Trade Creditors		135,955.68
For Freight-In		13,621.16
For Insurance (Business)	$ 440.86	
For Insurance (Apartment House)	59.99	500.85
For Interest (Business)	$ 177.15	
For Interest (Garage)	364.80	541.95
For Salaries and Wages (Business)	$ 14,756.74	
For Salaries and Wages (Apt. House)	1,080.00	15,836.74

For Taxes (Distribution as below)	$ 2,454.49
For Other Expenses (Distribution as below)	6,500.61
For Donation to Red Cross	25.00

1920 Expenses should be distributed as follows: (Items other than Insurance, Interest, Salaries).

Apartment House:	
Taxes	$1,469.29
Fuel	876.00
Repairs	102.75
Telephone	105.00
Water	353.00
Lights	177.50
Painting	232.70
Garage:	
Taxes	381.50
Home:	
Taxes	41.00
Business:	
Taxes	981.73
Delivery Expense	3,791.18
Advertising	25.00
Office and Miscellaneous Store Expenses	550.00

Problem Fifteen

You are requested by the president of the November Corporation to assist in the preparation of the federal income and excess profits tax return of his company for the current calendar year.

You are informed that the company was organized on January 1, 1910, with an authorized and issued capital of $4,150,000.00, divided as to:

Preferred stock	$1,650,000
Common stock	2,500,000

You are further informed that of this capital $1,000,000 common stock was sold to an underwriting syndicate for cash at par, less 6% commission, and that the remainder of the stock was issued to the vendor company in acquisition of the business, property, good will and other assets taken over. The capital stock outstanding has been unchanged from the date of organization to January 1, current year, except as to the redemption of the preferred stock indicated, which took place March 31, three years ago. The book values of the fixed properties are based on an appraisal made by an appraisal company as at March 1, 1913. In addition to the common stock dividend paid during the current year, the company issued a further $1,000,000 common stock, which was sold for cash at par as follows:

August 31	$500,000
October 31	500,000

On October 31, current year, it also redeemed for cash and retired preferred stock at par to the amount of $375,000.

You may assume the company was not engaged on any government contracts throughout the current year.

STATEMENT OF PROFITS AND INCOME
For the current year ending December 31

Sales		$25,000,000
Less cost of sales		15,000,000
Gross profit		$10,000,000
Deduct selling, general and administration expenses:		
Selling expenses		3,500,000
Advertising		500,000
Collection expenses		200,000
Contingent losses on bad and doubtful accounts		200,000
General office salaries		100,000
Profit-sharing bonus of executives		250,000
Taxes:		
Real and personal property taxes		50,000
Capital stock tax		5,000
Special assessments		10,000
Life insurance policy premiums		5,000
Charitable contributions:		
Public subscriptions		25,000
Employes' welfare		30,000
Total expenses		$4,875,000
Net profits from operations		$5,125,000
Add other income:		
Dividends received from domestic corporations	$100,000	
Dividends on foreign investments	50,000	
Interest received	10,000	160,000
		$5,285,000
Deduct:		
Interest paid	$250,000	
Proportion of bond discounts written off	10,000	260,000
Net profits and income		$5,025,000
Deduct:		
Expenses in connection with issue of capital stock	$ 50,000	
Provision for federal income taxes (preliminary estimate)	2,000,000	
Special reserve against inventory	500,000	2,550,000
Surplus net profits		$2,475,000

SURPLUS ACCOUNT
For the current year ending December 31

Balance at the beginning of the year			$2,650,000
Net profits for year			2,475,000
			$5,125,000
Less:			
Excess of federal taxes actually paid over amount provided at December 31, preceding year		$100,000	
Cash dividends paid on preferred stock during current year:			
January 31	$20,000		
April 30	20,000		
July 31	20,000		
October 31	15,000	75,000	
Dividends paid on common stock during current year:			
In cash			
February 28	$250,000		
August 31	250,000	500,000	
In stock			
August 31		1,000,000	
Preferred stock redemption fund		375,000	2,050,000
			$3,075,000

THE NOVEMBER CORPORATION

Condensed Trial Balance (After Closing)

For the current year from January 1 to December 31.

Accounts	January 1 Dr.	January 1 Cr.	December 31 Dr.	December 31 Cr.
Properties	$2,500,000		$3,500,000	
Depreciation Reserve		$500,000		$700,000
Good Will acquired for stock	1,500,000		1,500,000	
Investments in stock of other corporations at cost:				
Domestic (25% interest)	250,000		250,000	
Foreign (20% interest)	100,000		100,000	
Inventories	3,000,000		5,000,000	
Inventory reserves		500,000		1,000,000
Receivables	2,500,000		3,000,000	
Bad Debt reserves		100,000		250,000
Cash	1,400,000		2,000,000	
Bond discount	90,000		80,000	
Commission paid on issue of common stock	60,000		60,000	
Prepaid expenses	50,000		40,000	
Preferred Stock		1,500,000		1,125,000
Common Stock		2,500,000		4,500,000
Bonds		1,000,000		1,000,000
Current Liabilities		1,600,000		1,105,000
Provision for federal income and profits taxes		700,000		2,000,000
Contingent reserve		250,000		250,000
Preferred stock redemption fund		150,000		525,000
Earned surplus		2,150,000		2,575,000
Capital surplus resulting from appraisal of properties		500,000		500,000
	$11,450,000	$11,450,000	$15,530,000	$15,530,000

Draft statements showing:

(1) The amount of the company's "invested capital" for the year, which the treasury authorities will recognize for the purpose of computation of taxes.

(2) The taxable net income for the year.

(3) The amount of income and excess profits taxes assessable for the year. Inst. Ex.

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ILLUSTRATIONS